

1983

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Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness

Raymond T. Nimmer*

INTRODUCTION

When a bankruptcy petition is filed, section 362(a) of the federal Bankruptcy Code¹ imposes an automatic stay on various actions by creditors to collect their claims against the debtor, including actions to enforce a security interest by foreclosure against the debtor's property. Application of the automatic stay to secured creditors in business reorganization cases under Chapter 11 of the Code, however, presents significant issues involving a balance between protecting secured creditors and allowing debtors to restructure their business operations. Courts resolve these issues primarily by application of section 362(d)(1) of the Code, which permits relief from the automatic stay "for cause, including the lack of adequate protection" of the creditor's interest in the collateral.²

From the numerous reported decisions and articles on standards for relief from the automatic stay, two dominant and conflicting propositions emerge concerning the character of the protection to which the creditor is or should be entitled. The first provides that the creditor need only be protected against decline in the recoverable value of the collateral during the period in which the right to foreclose is barred by the automatic stay.³ The second proposition suggests that the creditor must also be compensated for lost use of the investment represented by the value of the collateral.⁴

This Article examines both propositions in light of the statutory framework and current case law, and concludes that neither proposition provides a valid policy ground or a valid model of the manner in which cases are currently decided.

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1. 11 U.S.C. § 362(a) (Supp. V 1981).

2. 11 U.S.C. § 362(d)(1) (Supp. V 1981).

3. See *infra* notes 21-34 and accompanying text.

4. See *infra* notes 35-51 and accompanying text.

Both propositions emphasize unitary economic constructs, whereas more sensitive and balanced analyses are required and are actually applied by the courts. The Article proposes a third model in which loss of recoverable value represents a baseline consideration, and in which further forms of protection are considered in a broad-based analysis encompassing the nature and history of the loan transaction, the behavior of the parties, and the prospects of or activity toward reorganization. Applying the proposed model to reported cases involving security interests reveals that the model approximates the manner in which cases are currently decided.

I. ADEQUATE PROTECTION: FRAMING THE ISSUE

The automatic stay imposed by section 362(a) of the Code applies in all bankruptcy proceedings and generally functions to channel post-petition collection issues into a single forum. Further operative purposes of the stay vary with the type of proceeding involved and the nature of the entity on which it is imposed.

In Chapter 11 reorganizations, a central function of the stay is to preserve the debtor's assets for a period adequate to accommodate efforts to restructure business operations and thus preserve a going concern. This function is ancillary to the overall objectives of a reorganization proceeding, described as follows in a congressional report on the Bankruptcy Code:

The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. . . . It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.⁵

The goal of reorganization is to optimize value to creditors by preserving the "going concern" value of the debtor's assets. In practice, this goal is often commingled with the view that the debtor has a protectable interest in economic survival.⁶

Regardless of the justification for reorganization, the automatic stay creates a potential transfer of value from the secured creditor to the debtor's estate which is most readily

5. H.R. REP. NO. 595, 95th Cong., 1st Sess. 220, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6179.

6. *See, e.g., In re Chugiak Boat Works, Inc.*, 18 Bankr. 292, 298 (Bankr. D. Alaska 1982); *In re Aurora Cord & Cable Co.*, 2 Bankr. 342, 346 (Bankr. N.D. Ill. 1980); *In re Heatron, Inc.*, 6 Bankr. 493, 496 (Bankr. W.D. Mo. 1980).

described as a potential, if not a presumptive, exchange of individual interests for collective benefits. The secured creditor's access to the collateral is deferred, thereby creating various potentials for individual loss, but the debtor's continued access to and use of the collateral may yield substantial benefits for the creditor community and the estate as a whole.

Absent restraints, an automatic stay would generate such transfers of value indiscriminately. Section 362(d)(1), however, provides that the automatic stay should be modified "for cause, including the lack of adequate protection of an interest in property."⁷ The issue of adequate protection may be raised in either of two contexts. Generally, the secured creditor must file a request for relief. In this context, notwithstanding any pre-petition default in the security agreement, the debtor's retention and continued use of the collateral is presumed until a request for relief is filed, whereupon the debtor assumes the burden of establishing that the creditor is adequately protected.⁸ The second context is limited to cases involving the use of cash collateral. Under section 363(c)(2), the debtor may not use cash collateral without prior authorization by the court.⁹ The court is required to place such limitations on the use of cash collateral as are necessary to "provide adequate protection."¹⁰

In either context, the standard of "adequate protection" mediates the conflicting interests of the creditor and the debtor's estate. The congressional report previously quoted described the role of adequate protection as follows:

[The] concept of adequate protection is based as much on policy

7. 11 U.S.C. § 362(d)(1) (Supp. V 1981). Section 362 also provides alternative grounds for relief from, or modification of, the stay. Although § 362(d)(1) has been the most often discussed, the alternative ground defined in 11 U.S.C. § 362(d)(2) (Supp. V 1981) has also been controversial. Section 362(d)(2) provides that relief from the stay should be granted if the debtor has no equity in the property and the property is not necessary to an effective reorganization. This provision was designed primarily to thwart efforts by highly leveraged real estate investors to use the automatic stay to delay foreclosure in order to gain tax advantages unrelated to reorganizational efforts. See S. REP. NO. 989, 95th Cong., 2d Sess. 52-53, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5838-39. Section 362(d)(2) is, thus, frequently raised as an issue in real estate cases. With the exception of stringent interpretations of "necessity" in consumer cases under Chapter 13, however, the standards actually employed under § 362(d)(2) generally conform to those employed in adequate protection analysis. See Nimmer, *Real Estate Creditors and the Automatic Stay: A Study in Behavioral Economics*, 1983 ARIZ. ST. L.J. —, —.

8. See 11 U.S.C. § 362(g) (Supp. V 1981).

9. See 11 U.S.C. § 363(c)(2) (Supp. V 1981).

10. 11 U.S.C. § 363(e) (Supp. V 1981).

grounds as on constitutional grounds. Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, this section recognizes the availability of alternate means of protecting a secured creditor's interest. Though the creditor might not receive his bargain in kind, the purpose of [section 361] is to insure that the secured creditor receives in value essentially what he bargained for.¹¹

Adequate protection is thus legislatively defined in terms of a balance between reorganization objectives and preservation of the creditor's contractual rights. Modification of the secured creditor's bargain is justified by the desire to provide an opportunity for the restructuring necessary to retain the going concern value of the debtor.¹² The concept of adequate protection interposes a basic limitation on this modification, entitling the creditor to receive "in value essentially what [was] bargained for."¹³

Implicit in this design is the supposition that the debtor's continued use of the collateral facilitates achievement of reorganization objectives. This connection between the secured property and the reorganization process is a basic prerequisite to justifying any limitation on the creditor's bargained-for rights. Although courts have varied in their descriptions of this requirement, they have generally recognized that the debtor must establish that the property is indeed needed for reorganization.¹⁴

The primary issue, assuming the collateral is needed for reorganization, concerns the conditions under which the stay should be retained or terminated. This issue can be addressed from two perspectives; both ultimately contribute to defining appropriate policy. The first perspective focuses on resolution of the equities between the two immediate parties and concerns the degree of risk or restraint justified by the particular

11. H.R. REP. NO. 595, 95th Cong., 1st Sess. 339, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 6295.

12. As noted previously, the functional purposes of the stay vary with the type of proceeding in which the stay is being applied. In liquidation cases, the primary role of the stay is to stabilize collection activities and allow for orderly collection and liquidation of assets. A conceptual problem arises in applying the stay in Chapter 11 proceedings contemplating substantial liquidation of the debtor's assets. See *In re Koopmans*, 22 Bankr. 395 (Bankr. D. Utah 1982).

13. See *supra* note 11 and accompanying text.

14. See Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. MICH. J.L. REF. 175, 245-59 (1978). Although the focus at this level is on need, ultimately it is necessary to establish the feasibility of reorganizing. *Id.* See *In re Terra Mar Assocs.*, 3 Bankr. 462, 466 (Bankr. D. Conn. 1980) (regarding 11 U.S.C. § 362(d)(2) (Supp. V. 1981)); Nimmer, *supra* note 7, at —.

context. For example, where a creditor assumed atypical risks through pre-petition conduct,¹⁵ continuation of those risks may be appropriate, especially where potentially successful efforts toward reorganization are present. Conversely, where the debtor has entered bankruptcy for the sole purpose of delay, termination of the stay may be appropriate.¹⁶ The variations are numerous, but the critical aspect is that analysis is confined to the individual parties involved in a specific case.

In contrast, the second perspective focuses on the broader implications for general patterns of secured financing. Section 362 alters the secured creditor's right to relatively immediate access to its collateral after default. To the extent this modification reduces the perceived value of security interests in general, there will be corrective effects in the cost of secured credit and in creditors' willingness to lend.¹⁷ While some impact is unavoidable, an appropriate goal is to pursue reorganization objectives in a manner that maximizes potential gain to the estate while minimizing effects detrimental to secured lending.

As indicated by the section 362 reference to protecting an "interest in property" and the congressional reference to the "essential value" of the creditor's bargain, the statute intends to establish a basic minimum beyond which the secured creditor's rights may not be infringed.

II. DEFINING THE BARGAIN

The basic distinguishing factor of a secured loan is the creditor's right to ultimately rely on selected collateral for recovery of all or part of the loan. The character of that right is affected by the nature of the property and the ratio of the property's value to the size of the outstanding obligation. By imposing a conditional delay on foreclosure, section 362 potentially affects this right whenever the recoverable value available to the creditor is declining. As will be discussed below, it is generally agreed that protection against this effect is implicit within the concept of adequate protection.¹⁸

Beyond this interest in collateral, however, the interests of

15. See *In re El Patio, Ltd.*, 6 Bankr. 518, 523 (Bankr. S.D. Cal. 1980); *In re Orlando Coals, Inc.*, 6 Bankr. 721, 724-25 (Bankr. S.D. W. Va. 1980).

16. See *In re Andrews*, 17 Bankr. 515, 519 (Bankr. C.D. Cal. 1982); *In re Eggers*, 19 Bankr. 225, 226 (Bankr. M.D. Fla. 1982).

17. See Jackson, *Bankruptcy, Nonbankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 877 (1982); Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1148 (1979).

18. See *infra* text accompanying notes 21-34.

secured creditors and unsecured creditors are in some instances congruent. Both, for example, share expectations that the debt will be repaid voluntarily and that there will be a periodic cash flow under the terms of the note. With regard to both of these expectations, the secured creditor's existing property interest in the collateral operates as a lever encouraging payment.¹⁹ Further, both secured and unsecured creditors anticipate a return on their investment in the form of interest. Secured creditors are distinguished from other creditors, however, by the relative ease with which they can normally recover and reinvest assets through foreclosure if payments are not forthcoming. Arguably, by delaying the right of foreclosure, section 362 creates a situation in which secured creditors should be compensated for lost reinvestment opportunities.²⁰

Depending on the nature of the loan transaction, the relationship between the secured creditor and the debtor may be substantially more complex than described thus far. For example, in various contexts the creditor does not rely on the current collateral, but relies instead on the debtor's operations to transform the collateral and produce a net gain. Such reliance is common in real estate construction or conversion loans, as well as in floating lien financing on inventory or accounts receivable. Because of the substantial reliance on, and interest in, the debtor's current operations, these transactions are more akin to joint ventures than to static, traditional types of debt relationships. In such transactions, the expectation of gain from the debtor's operations forms part of the value of the creditor's bargain.

Against this complex background, attempts to develop a conceptual framework for adequate protection have been surprisingly limited and incomplete. Two dominant approaches have developed, but, as will be seen, both are limited to purely financial elements, ignoring behavioral and transactional factors. Both fail because they attempt to define universal standards independent of significant contextual and transactional variations.

A. RECOVERABLE VALUE

The first approach defines adequate protection in terms of the current recoverable value of the collateral to the creditor.

19. See 1 P. COOGAN, W. HOGAN, D. VAGTS & J. McDONNEL, *SECURITY TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* § 1.04(3) (1983).

20. See *infra* text accompanying notes 36-51.

Under this view, adequate protection requires attention to such factors as depreciation, damage, and the accrual of senior interests, to the extent these factors reduce the amount that the individual creditor can recover from the collateral. Where excess collateral or the absence of depreciation ensures no reduction in recoverable value, the adequate protection standard is satisfied without any further action by the debtor. For example, in *In re Alyucan*,²¹ a real estate case arising under section 362, the court retained the automatic stay with the following comments:

[T]he "interest in property" entitled to protection is not measured by the amount of the debt but by the value of the lien. A mushrooming debt, through accrual of interest . . . may be immaterial, if the amount of the lien is not thereby increased, while vicissitudes in the market, loss of insurance or other factors affecting the value of the lien are relevant

In this proceeding, the . . . lien of Bankers Life . . . is a first lien The collateral and therefore the lien are not declining or subject to sudden depreciation in value. Bankers Life is suffering no pain cognizable under Section 362 as a result of the stay, and relief from the stay is therefore, at this juncture, unnecessary.²²

Although commentators frequently criticize this view of adequate protection as too limited, they often assume it to be the one adopted by Congress.²³ This conclusion is suggested by other sections of the Code and the legislative history of section 362. For example, section 361 of the Code illustrates three modes through which adequate protection may be furnished to a creditor. Included are periodic cash payments and replacement liens "to the extent that [the] stay . . . results in a decrease in the value of [the creditor's] interest in [the] property."²⁴ In describing the option of periodic cash payments, the Senate committee report noted:

The use of periodic payments may be appropriate where, for example, the property in question is depreciating at a relatively fixed rate. The periodic payments would be to compensate for the depreciation and might, but need not necessarily, be in the same amount as payments due on the secured obligation.²⁵

Furthermore, in reporting the final draft of the Code on the floor of Congress, the sponsors noted that "[a]dequate protection . . . is intended to protect a creditor's allowed secured

21. 12 Bankr. 803 (Bankr. D. Utah 1981).

22. *Id.* at 808-09 (footnote omitted).

23. See, e.g., Fortang & King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. REV. 1148, 1154-56 (1981); Note, *Automatic Stay Under the 1978 Bankruptcy Code: An Equitable Roadblock to Secured Creditor Relief*, 17 SAN DIEGO L. REV. 1113, 1132 (1980).

24. 11 U.S.C. § 361(2) (Supp. V 1981).

25. S. REP. NO. 989, 95th Cong., 2d Sess. 54, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5840.

claim.”²⁶ Under section 506(a) of the Code an “allowed claim . . . is a secured claim to the extent of the value of [the] creditor’s interest . . . in such property.”²⁷ The focus is on the value of the property recoverable by the creditor, and thus the thrust of adequate protection is to prevent or compensate for any reduction in such value.

The recoverable value approach to adequate protection is further suggested by earlier drafts of the current Code. The automatic stay provisions of the Code derive in part from draft legislation prepared by the Commission on the Bankruptcy Laws of the United States. In its report, the Commission described adequate protection as related to “the anticipated decrease in the value of collateral as a result of use.”²⁸ The objective of the standard was to permit use of the property subject to payments or other transfers that would compensate the secured creditor for the decline in recoverable value.²⁹

In assessing the relationship between adequate protection and recoverable value, it is necessary to distinguish two propositions. The first is that protection against or compensation for loss is *included within* adequate protection. This limited premise is amply supported by the Code and its legislative history. Indeed, since the adoption of section 362, there has been little debate that such protection or compensation represents a baseline requirement for retention of the automatic stay. The creditor’s ultimate right to recover from the property is inherent in all secured loans and, to the extent that adequate protection is intended to preserve the value of the bargain to the creditor, protection against or compensation for a loss in the value of the collateral must be included.

A second proposition, often expressed in juxtaposition to claims that adequate protection requires compensation for other financial losses,³⁰ is that protection of recoverable value represents the *sole element* of adequate protection. The pri-

26. 124 CONG. REC. 32, 395 (1978) (remarks of Congressman Edwards).

27. 11 U.S.C. § 506(a) (Supp. V 1981).

28. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, pt. II, H.R. DOC. NO. 137, 93 Cong., 1st Sess. 237 (1973) [hereinafter cited as COMMISSION REPORT].

29. See *id.* at 236. The Commission referenced this approach to the pre-Code case of *In re Bermec Corp.*, 445 F.2d 367 (2d Cir. 1971), in which the court conditioned the stay on payments equivalent to the “economic depreciation” of the property. Significantly, perhaps, *Bermec* involved a loan secured by the debtor’s equipment. As discussed below, under the Code, depreciation tends to be the primary financial issue in equipment cases. See *infra* text accompanying notes 59-69.

30. See *In re Alyucan Interstate Corp.*, 12 Bankr. 803, 806 (Bankr. D. Utah

mary support for this proposition lies in a negative inference drawn from the legislative history and final version of the Code: although protection against reinvestment opportunity losses was discussed in the legislative process along with recoverable value protection, only the latter was clearly enacted within the Code.³¹ While it is possible to infer that opportunity cost was thus excluded from the concept of adequate protection, there are clear indications that Congress did not intend to exclude it in all cases.³²

The proposition that adequate protection is limited solely to protection of recoverable value is strongly oriented toward the interests of the estate at the expense of the secured creditor. Applied in pure form, it contemplates protective action only to the extent that recoverable value actually declines or there is a risk of decline. When property value is stable, the debtor has access to the benefits of continued use of the property on a cost-free basis, resulting in a transfer of value to the estate, while the creditor is locked into an investment without compensating income. This situation raises serious questions of individual fairness, especially where the investment is large and the delay is lengthy. Furthermore, the risk of such loss may affect the cost and availability of secured lending,³³ and may create an incentive for premature foreclosure on existing liens.³⁴

1981); *In re American Mariner Indus., Inc.*, 10 Bankr. 711, 712-13 (Bankr. C.D. Cal. 1981).

31. See, e.g., *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong., 2d Sess. 1799 (1976) (reprinting Murphy, *Use of Collateral in Business Rehabilitations: A Suggested Redrafting of the Bankruptcy Reform Act*, 63 CALIF. L. REV. 1483 (1975)).

32. See *infra* text accompanying notes 39-44.

33. See, e.g., Jackson, *supra* note 17, at 877.

34. The incentive for premature foreclosure to avoid entanglement in bankruptcy may not relate solely to tangible or identifiable economic effects. In any event, however, the extent to which the incentive is acted upon will relate to the effectiveness of pre-filing foreclosure in removing the collateral from the estate. If this result can be achieved by physical seizure without pre-filing sale, the desirability of preemptive action is increased by the increased likelihood that it will succeed. In contrast, if the property remains in the estate until a sale is completed, the incentive to act is reduced since it is less likely that the creditor will be able to avoid entanglement in the bankruptcy case. The point in the foreclosure process at which the property is effectively removed from the estate has been the subject of significant controversy. The Supreme Court, however, recently provided some clarification, holding that repossession of the debtor's property prior to bankruptcy does not remove the property from the reorganization estate. *United States v. Whiting Pools, Inc.*, 103 S. Ct. 2309, 2315 (1983).

B. OPPORTUNITY VALUE

The foregoing model assumes that significant detriments may be imposed on secured lenders. A competing model argues that adequate protection requires more extensive financial protection, approximating a full equivalence of bargained-for benefits other than the immediate right to foreclose. In practice, this model is often presented in connection with the view that secured creditors should be compensated for lost reinvestment opportunities.³⁵

This additional compensation is in part supported by equitable considerations relating to the individual creditor. Writing prior to the adoption of the current Code, Patrick A. Murphy argued:

[I]f the interim cash payments alternative is used, perhaps the secured creditor should receive interest or compensation for its cost of funds.

This . . . idea may seem shocking at first because it has been long recognized in bankruptcy that a secured creditor is entitled to the payment of interest only in the event that it holds surplus security Nevertheless [i]f the stay of the marginally secured creditor is properly viewed as an involuntary loan of property to the debtor, there seems little reason not to afford the secured creditor some protection against the ravages of inflation and the fact that his own creditors have not given him an interest moratorium.³⁶

This position is also partly supported by the goal of minimizing the adverse effects of the automatic stay on secured lending patterns under nonbankruptcy law.

A major difficulty with this model of adequate protection is the paucity of support for it within the Code and its legislative history. Commentators urging protection of opportunity values often acknowledge that it is not mandated by the Code.³⁷ To the extent that it is argued that this protection is required under current law, the analysis typically focuses on interpretation of the reference in section 361 to "the value of [the creditor's] interest in . . . property" in light of the congressional reference to protecting the "value" for which the creditor bargained. An example is the discussion in *In re Monroe Park*, where the court noted:

If [the creditor] had been allowed to foreclose on the mortgaged property at the time the bankruptcy petition was filed, it could have re-invested the money gained . . . at current interest rates This right of recourse to the collateral is an important part of the value of

35. See, e.g., Fortang & King, *supra* note 23, at 1153-65; Jackson, *supra* note 17, at 872-77; Murphy, *supra* note 31, at 1506.

36. Murphy, *supra* note 31, at 1506.

37. See, e.g., Fortang & King, *supra* note 35, at 1150; Jackson, *supra* note 17, at 877.

[the creditor's] interest in property which must be fully protected. . . . [I]t was incumbent upon [the debtor] to provide some form of relief which would compensate [the creditor] for the loss of use of its money or to supply some 'indubitable equivalent' of the accruing interest.³⁸

The court's discussion illustrates a tendency to blend references to "value" with the references to "indubitable equivalent." The latter term is found in section 361, which lists several illustrative forms of adequate protection, one of them being any method designed to provide the "indubitable equivalent" of the creditor's interest.³⁹ The language derives from the pre-Code case of *In re Murel Holding Corp.*,⁴⁰ which dealt with confirmation standards under former section 207(b) (5) and held that treatment of the secured creditor must be

completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that . . . unless by a substitute of the most indubitable equivalence.⁴¹

Thus, the statutory reference to "indubitable equivalent" suggests that opportunity cost or interest is an appropriate element of adequate protection. But *Murel* goes further, indicating that interest alone may not be adequate if other factors indicate a risk of ultimate nonpayment.

In assessing the role of opportunity cost in adequate protection, it is necessary to distinguish two propositions analogous to those previously noted in reference to the recoverable value model. The first, which has strong statutory support, is that compensation of opportunity cost and other financial elements of a bargain is appropriate in *some* cases.⁴² Adequate protection was proposed and enacted as a flexible remedy to be tailored to the specific case and this element of protection might be desirable in some contexts. Furthermore, as the preceding discussion indicates, the statutory reference to "indubitable equivalent" suggests that issues beyond recoverable value are properly considered within adequate protection. It is a misinterpretation of section 361, however, to view indubitable equivalence as a baseline protection applicable in all cases.

38. *In re Monroe Park*, 17 Bankr. 934, 940 (D. Del. 1982) (citations omitted).

39. 11 U.S.C. § 361(c) (Supp. V 1981).

40. 75 F.2d 941 (2d Cir. 1935).

41. *Id.* at 942.

42. See, e.g., 11 U.S.C. § 361(3) (Supp. V 1981). See also *supra* text accompanying note 41.

The illustrative, nonexclusive list of adequate protection formats in section 361 juxtaposes indubitable equivalence with two other formats that are expressly concerned with depreciation or dissipation of recoverable value. The apparent meaning is that any of these, or other analogous formats, may be appropriate in selected cases and that compensation for opportunity cost is *not precluded* by the Code.

Similarly, other portions of the Code expressly protect the secured creditor's opportunity cost in selected cases. For example, although interest is generally not allowed to accrue after the bankruptcy petition, an exception is made for the claims of oversecured creditors.⁴³ While this exception applies to allowed claims and not to adequate protection, it indicates a willingness to incorporate post-petition investment interests in at least some cases. Indeed, in the context of real estate cases, many courts use this exception to protect reinvestment opportunities without discussion of the underlying doctrinal issue.⁴⁴

The second, alternative proposition is that compensation for opportunity cost is required in *all* cases. Although the Code provides only marginal support for this view, several courts have directly or indirectly adopted it.⁴⁵ This proposition relies on policy considerations related to defining the proper relationship between the secured creditor and the bankruptcy estate. It is premised on the goals of fairness to individual creditors and minimal interference with "normal" patterns of secured financing. "Normal" in this context is defined as financing under prevailing non-bankruptcy law. The ultimate premise is that bankruptcy rules should avoid inconsistency with these external norms.⁴⁶

This view is often supported by general references to the importance of secured financing and to the expectation that any diminution of secured creditors' rights under bankruptcy law will adversely affect the cost and availability of credit. A recent article by Thomas Jackson attempts to elevate this posi-

43. See 11 U.S.C. § 506(b) (Supp. V 1981).

44. See *In re Alyucan Interstate Corp.*, 12 Bankr. 803, 808 n.10 (Bankr. D. Utah 1981); Nimmer, *supra* note 7, at —. Arguably, however, even for oversecured creditors, § 506(b) should not be viewed as requiring post-petition accumulation of interest in all cases. See O'Toole, *Adequate Protection and Postpetition Interest in Chapter 11 Proceedings*, 56 AM. BANKR. L.J. 251, 271-72 (1982).

45. See, e.g., *In re Monroe Park*, 17 Bankr. 934, 940 (D. Del. 1982); *In re Virginia Foundry Co.*, 9 Bankr. 493, 498 (W.D. Va. 1981); *In re Anchorage Boat Sales, Inc.*, 4 Bankr. 635, 643 (Bankr. E.D.N.Y. 1980).

46. See COMMISSION REPORT, *supra* note 28, pt. I, at 68-74.

tion to a policy-based model concerning intercreditor distribution rules.⁴⁷ Jackson suggests that bankruptcy rules allocating resources among creditors should be designed in terms of the bargain that economically rational creditors would be expected to negotiate *ex ante*. From this model, and the assumption that secured lending results in "aggregate efficiencies" benefiting both secured and unsecured creditors, Jackson concludes that adequate protection should be defined so that, economically, the secured creditor will be "indifferent as between receiving . . . cash, today, and leaving [the collateral in possession of the debtor]." ⁴⁸ This requires, in Jackson's view, reference to "market-pricing mechanisms" to compensate the creditor for delayed access to the collateral. Withholding such compensation, according to Jackson, results in economically inefficient reactions, such as increased charges for secured loans, value transfers from the secured creditor to the estate, and efforts to avoid these transfers through complex negotiation or precipitous action to foreclose prior to bankruptcy.⁴⁹

In developing his analysis, Jackson focuses on a hypothetical creditor fully secured by the liquidation value of the collateral, and generates a judgment allegedly applicable to all cases. Even if one accepts the underlying premise that a secured creditor will act rationally to avoid potential economic loss, the more accurate thrust of Jackson's model is that interest on the claim may be appropriate in *some* cases. For example, a creditor who is undersecured in terms of liquidation value may gain more through reorganization than by receipt of interest since the value of the property might be enhanced. In such a case, an economically rational creditor has no incentive to undertake avoidance reactions. Consequently, there is no potential for adverse effects on general patterns of secured financing as a result of not recognizing "opportunity cost" as an element of adequate protection.

Jackson's analysis also fails to account for the effect of "opportunity cost" compensation on the ability of the debtor to reorganize. Imposition of these costs through "market pricing"

47. Jackson, *supra* note 17.

48. *Id.* at 873.

49. *See id.* at 875. Based on a review of a limited number of cases, Jackson purports to examine the "actual operation" of the Code and concludes that "in actual application it appears that this value-equivalence is consistently undermined." *Id.* at 872. As will be discussed, however, a closer review of the cases reveals a substantially more complex pattern than Jackson's assessment suggests. Depending on the type of property involved, courts make substantial efforts to protect the value equivalent of security interests.

may effectively preclude reorganization in many cases, barring acknowledged benefits to the estate. In such cases, potentially adverse effects on secured financing must be balanced against net economic loss to all creditors. Compensation for opportunity cost is not necessarily the sole or most significant component of this balance. Protection of recoverable value, combined with other nonfinancial safeguards, may be adequate in at least some cases, as was suggested by the court in *In re South Village, Inc.*⁵⁰ In denying compensation for opportunity cost in a real estate context, the court noted:

Adequate protection is the fulcrum upon which the rights of debtors and creditors are balanced in a reorganization case. Congress knew that the payment of interest would be an impossible burden for debtors, many of whom file because of cash shortages. . . .

Congress, however, did not leave creditors unarmed against the attrition . . . worked by time. [Various remedies are] tailored to solve the problem of delay. Adequate protection, which preserves the allowed secured claim and these prophylactics against obstruction in a case complement one another.⁵¹

Thus, the purported justification for Jackson's model applies only to selected cases, rather than uniformly to all cases. Even in these selected cases the basic model is questionable because it is built on an assumption of economically rational actors operating to optimize benefits. In such an environment, market pricing might make secured creditors indifferent to delay of foreclosure. But different behavioral assumptions generate different results; as a result, compensation based on market pricing may fail to generate the desired indifference and make avoidance reactions less attractive. Even if the policy goal of avoiding adverse effects on secured lending is accepted, determination of the appropriate elements of adequate protection requires a model more sensitive to differing behavioral assumptions.

III. AN OPERATIONAL MODEL

The purpose of an analytical model is either to describe the current status of the law, or to define a framework that describes what the law should be. In pure form, the two models of adequate protection discussed above fail on both grounds: they neither describe the current posture of the law nor develop a thorough analysis of the factors that should be examined to determine adequate protection.

50. 25 Bankr. 987 (Bankr. D. Utah 1982).

51. *Id.* at 1002.

To the extent that they seek to define absolute requirements within adequate protection, both the recoverable value and the opportunity cost models hypothesize artificial constraints not justified by the statutory framework. A focus on recoverable value to the exclusion of other forms of protection results in an excessive emphasis on maximizing value to the debtor at the expense of individual creditors and secured financing in general. This focus is not justified by the statute's history, which speaks of protecting essential elements of the bargain, or by its provisions, which recognize indubitable equivalence as one permissible form of protection. Conversely, a uniform requirement of compensation for opportunity cost emphasizes full protection of the secured creditor at the possible expense of seriously impeding reorganization opportunities, and cannot be justified by a statute that accentuates flexibility and reorganization.

Neither model adequately describes the various factors actually employed in current case law. While many courts retain or remove the automatic stay based on findings limited to protection of recoverable value, many others have granted relief from the stay despite an absence of allegation or proof of a loss of recoverable value.⁵² Similarly, while numerous courts have implemented compensation for opportunity cost as an element of adequate protection,⁵³ many others have denied relief from the stay without compensation for opportunity costs, or have granted relief despite existing mechanisms for compensation.⁵⁴ As a matter of policy and practice, issues of adequate protection are substantially more complex than either model suggests.

Structuring a more descriptive model initially requires identification of the underlying points of consensus. For instance, it is clear that imposition and retention of the stay is not justified unless the subject property has some relation to

52. See, e.g., *In re Andrews*, 17 Bankr. 515 (Bankr. C.D. Cal. 1982); *In re Brogden Inv. Co.*, 22 Bankr. 546 (Bankr. N.D. Ga. 1982); *In re Caringi*, 19 Bankr. 12 (Bankr. M.D. Pa. 1982); *In re Kingman Warehouse Co.*, 17 Bankr. 377 (Bankr. D. Iowa 1982); *In re Hayden Dev. Co.*, 10 Bankr. 765 (Bankr. E.D. Pa. 1981).

53. See, e.g., *In re Monroe Park*, 17 Bankr. 934 (D. Del. 1982); *In re Earth Lite, Inc.*, 9 Bankr. 440 (Bankr. M.D. Fla. 1981); *In re Virginia Foundry Co.*, 9 Bankr. 493 (W.D. Va. 1981); *In re Anchorage Boat Sales, Inc.*, 4 Bankr. 635 (Bankr. E.D.N.Y. 1980).

54. See, e.g., *Ukrainian Sav. & Loan v. Trident Corp.*, 22 Bankr. 491 (E.D. Pa. 1982); *In re A & A Transport, Inc.*, 10 Bankr. 867 (Bankr. D. Mass. 1981); *In re American Mariner Indus., Inc.*, 10 Bankr. 711 (Bankr. C.D. Cal. 1981); *In re Kleinsasser*, 12 Bankr. 452 (Bankr. D.S.D. 1981); *In re Hutton-Johnson Co.*, 4 Bankr. 855 (Bankr. S.D.N.Y. 1980).

the potential success of the reorganization. At this level, it is not necessary that feasibility of reorganization be established. Rather, the core requirement is simply an elemental connection that is commonly satisfied in business cases.⁵⁵ In addition, it is equally clear that adequate protection requires, as a basic element, protection of the recoverable value available to the creditor. This premise is supported throughout the legislative history of the Code and is seldom disputed. As a policy matter, it places a basic limit on the extent to which secured creditors' interests may be impaired in reorganization proceedings. This limit may not maximally protect secured creditors, but it does protect perhaps the most basic component of secured transactions—the ultimate ability to recover from the property—insofar as that right has been preserved prior to bankruptcy.

These elements define a basic core of adequate protection and establish limiting parameters within which the interests of the creditor and the estate are balanced. Beyond this core, a variety of factors must be considered and balanced in the analysis of each case. Pertinent factors include the desirability and feasibility of compensation for opportunity cost in the particular context. The balancing should not, however, be confined solely to identifiable financial factors. Instead, upon establishment of core protection, the analysis must focus on balancing the rights of two entities with conflicting claims to the same property. The rights of both are qualified rather than absolute. The objective is to define a contextually optimal balance in recognition of the instant dispute, as well as the potential impact on broader patterns of secured financing.

The flexible character of adequate protection analysis is suggested throughout the Code and its legislative history. For example, section 362(d) broadly provides relief “for cause, including the lack of adequate protection,” suggesting that adequate protection is merely a component of a broader concept that explicitly incorporates a relatively open-ended analysis.⁵⁶

Similarly, the House committee report concerning section 361 notes:

The . . . means . . . of providing adequate protection . . . are neither exclusive nor exhaustive It is expected that the courts will apply the concept in light of facts of each case and general equitable principles There are an infinite number of variations possible in dealings between debtors and creditors, the law is continually developing,

55. See *infra* note 154.

56. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 343, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 6300.

and new ideas are continually being implemented The flexibility is important to permit the courts to adapt to varying circumstances and changing modes of financing.⁵⁷

This equitable analysis requires consideration of two broad areas. The first involves the characteristics of the loan transaction. The legislative history of the Code indicates that adequate protection is designed to protect the value of the creditor's bargain. Secured lending, however, is not a unitary phenomenon; it exists in a variety of contexts involving different forms of risk and reliance. Adequate protection analysis should reflect this contextual diversity and should also be sensitive to the manner in which the bargain has been performed prior to bankruptcy.⁵⁸

The second general area involves behavioral considerations and encompasses the debtor's conduct and current prospects for reorganization. The right to continued use of the collateral is neither absolute nor unrelated to overriding objectives. It is appropriate to review the debtor's behavior toward the creditor as well as the debtor's apparent purpose in filing for bankruptcy. An element of fair dealing and good faith effort, implicit in an equitable conception of adequate protection, should guide courts in deciding whether to continue to restrain a creditor. Similarly, courts should examine the likelihood that a debtor will be able to achieve the objectives that are implicit in a reorganization case. The extent of this assessment is time related; a prolonged period of restraint requires an increased likelihood of success.

Thus, the appropriate model entails a fluid assessment of adequate protection. Such fluidity is necessary to permit courts to optimize the balance between creditor and debtor in individual cases. Nevertheless, it also generates substantial protection of the interests inherent in secured financing. The core protection of recoverable value establishes a basic minimum protection that is enhanced by sensitivity to behavioral contexts and particular transactional risks. The ensuing discussion demonstrates that this approach traces the manner in which courts have examined adequate protection, and establishes a framework to explain and focus the disparate patterns that have developed in the cases.

57. *Id.* at 339, 1978 U.S. CODE CONG. & AD. NEWS at 6295.

58. See *In re Orlando Coals, Inc.*, 6 Bankr. 721, 724 (Bankr. S.D. W. Va. 1980) (delayed foreclosure); *In re Rogers Dev. Corp.*, 2 Bankr. 679, 682 (Bankr. E.D. Va. 1980) (post-default advances).

IV. COMMERCIAL LENDING

The suggested model for automatic stay litigation involves a two-level analysis. The first level establishes a baseline protection of recoverable value and ascertains the requisite preliminary connection between retention of the property and the reorganization effort. The second level involves specification of the causes for, and the types of, extended adequate protection. The analysis should differentiate cases on the basis of the type of transaction, and the behavior and prospects of the parties. The objective is to reconstruct the secured creditor's bargain in light of the prevailing equities and the feasibility of reorganization.

Under this model, one would anticipate substantial differences in the handling of protection issues across the various types of property financing. Within the context of non-real estate commercial lending, these differences can be seen through comparison of cases involving equipment financing and cases involving floating collateral such as inventory and accounts receivable. By focusing on cases within these categories, it becomes apparent that courts are indeed attempting to structure adequate protection standards in a manner that reflects underlying differences in transactions and in the behavior of the parties.

A. EQUIPMENT

Under article 9 of the Uniform Commercial Code, the generic term "equipment" encompasses a wide variety of commercial personal property.⁵⁹ The distinguishing characteristic of "equipment" is that it consists of tangible goods used in a business, rather than items held for sale or used by a consumer. In terms of the relative durability and value of a single item, equipment can range from small, short-lived, and inexpensive items to relatively large, durable machines.

Despite this diversity, commercial financing of equipment is generally associated with heavy equipment of at least several years normal durability. This generalization clearly applies to a majority of the reported cases involving equipment finance, and is significant for the model suggested in this Article since financing of such equipment is commonly characterized by single payment loans to be repaid from general revenue or resources. From the creditor's perspective, the role of the

59. See U.C.C. § 9-109 (1978).

collateral in this context approximates traditional notions about secured lending—a relatively large asset with significant and somewhat stable value serving as ultimate recourse for the loan.

1. Core Protection

The core elements of adequate protection consist of preventing a decrease in recoverable value of the property, and establishing that the collateral is related to reorganization efforts. In most reported cases dealing with equipment, the requisite connection with the proceeding is apparent and may be stipulated by the parties.⁶⁰ Thus, the central issue in most cases relates to potential lost value.

Although equipment financing is relatively static in terms of the debtor's long term use of the collateral, the property is subject to changes in value over time, typically involving depreciation of property values. When depreciation is established, unless the creditor is substantially oversecured, there is an immediate and continuing reduction in recoverable value. As a result, courts recognize that some form of offsetting protection for depreciation loss is a prerequisite to retaining the automatic stay.⁶¹

Most courts respond to depreciation loss by ordering periodic cash payments to match depreciation rates.⁶² Actual payments are necessary because the creditor is typically undersecured at the time of bankruptcy due to rapid, early depreciation and pre-petition defaults by the debtor. The cash payment requirement, however, is linked to current depreciation. Courts, appropriately, have not undertaken retroactive correction of the debt-to-collateral ratio, but have assumed that adequate protection functions with reference to the creditor's situation at the time of petition.⁶³ In the few cases in which the creditor is oversecured, cash payments are unnecessary until

60. Compare *In re A & A Transport, Inc.*, 10 Bankr. 867 (Bankr. D. Mass. 1981) (parties agreed that two tractors subject to creditor's security interest were "essential" to debtor's operations) and *In re Kleinsasser*, 12 Bankr. 452 (Bankr. D.S.D. 1981) (parties stipulated that seven trucks subject to creditor's security interest were necessary to an effective reorganization by debtor) with *In re Farina*, 9 Bankr. 726 (Bankr. D. Me. 1981) (debtor country club failed to establish that tractor was necessary to its operations).

61. See, e.g., *In re American Mariner Indus., Inc.*, 10 Bankr. 711, 714 (Bankr. C.D. Cal. 1981); *In re Coors of the Cumberland, Inc.*, 19 Bankr. 313, 322 (Bankr. M.D. Tenn. 1981); *In re Kleinsasser*, 12 Bankr. 452, 455 (Bankr. D.S.D. 1981).

62. See 11 U.S.C. § 361(1) (Supp. V 1981).

63. See, e.g., *In re Wheeler*, 12 Bankr. 908, 909 (Bankr. D. Mass. 1981).

depreciation reduces recoverable value to the point that it threatens to dip below the size of the obligation.⁶⁴

Although depreciation is the major, recurrent threat to recoverable value, depending on the particular type of collateral involved, courts may emphasize additional factors. For example, in terminating the stay against repossession of strip mining equipment, the court in *In re Champion Coal Co.*⁶⁵ was "influenced by evidence that . . . there is a high risk of major repairs being required regularly."⁶⁶ Absent a proven ability to finance or compensate for these repairs, the creditor's recoverable value was exposed to a risk of sudden depletion.⁶⁷ Similarly, in *In re Paradise Boat Leasing Corp.*,⁶⁸ the court terminated the stay, emphasizing that pleasure boats are "easily destroyed" and that insurance maintained by the debtor did not cover all significant risks of such loss.⁶⁹

2. Reconstructing the Bargain

The significant feature of the equipment cases is that protection against depreciation or other value loss is the only form of financial protection required to safeguard the creditor. This is in marked contrast to the multiple protections found in inventory cases and also differs from the protections adopted in the reported real estate cases. The unique nature of the protection required in equipment cases is directly attributable to the relatively static and low risk character of equipment financing, which delimits the extent to which courts will reconstruct the essential values of the transaction.

It is undoubtedly true that lenders secured by an interest in equipment bargain for a cash flow and interest on their investment. These elements of the bargain are indistinguishable from the bargained-for value of all loan transactions. Unlike floating lien financing, however, in the equipment context there is no ongoing interaction between the lender and the debtor's operations, and there is relatively little risk of loss of the stable collateral. Absent these factors, the equipment cases stand for the proposition that cash flow and opportunity cost are not integral, protectable features of the creditor's bargain. In general,

64. See *In re Xinde Int'l, Inc.*, 13 Bankr. 212, 215-16 (Bankr. D. Mass. 1981); *In re 5-Leaf Clover Corp.*, 6 Bankr. 463, 466-68 (Bankr. S.D. W. Va. 1980).

65. 21 Bankr. 733 (Bankr. W.D. Pa. 1982).

66. *Id.* at 735.

67. *Id.*

68. 2 Bankr. 482 (Bankr. D.V.I. 1979).

69. *Id.* at 484.

these elements will be protected only if the debtor gratuitously offers to do so or if failure to do so threatens recoverable value.⁷⁰

One might argue that this limited view of the equipment creditor's bargain is undesirably restrictive. The cases are, however, relatively uniform on this point. In fact, two of the reported cases wherein opportunity cost is expressly rejected as an element of adequate protection arose in the equipment context.⁷¹ This result was foreshadowed by testimony on the proposed Bankruptcy Code:

The order in most cases . . . should make provision for compensation to the secured party . . . I think that this would be a relatively simple provision in the case of machinery and equipment where the exposure to the creditor could be fairly well determined in advance and where the risk to the creditor is . . . not that serious, for static assets are involved.⁷²

This testimony not only foreshadowed the current treatment of equipment loans, but also suggests a basis for distinguishing these transactions with respect to protection of cash flow and opportunity cost. The relatively slight and predictable risk to creditors in equipment financing provides a basis for not protecting their interests in cash flow and opportunity cost in this context.

The equipment cases are also distinguished by the absence of an analytical tool commonly discussed in real estate cases. Courts display an apparent tendency in real estate cases to condition the continuance of a stay, at least in part, on the presence and protection of an equity cushion,⁷³ that is, the amount by which the value of the security exceeds the debt. A significant aspect of the cushion is that it provides a convenient format for accumulation of post-petition interest without any payments by the debtor.⁷⁴ Although few equipment cases in-

70. See *In re American Mariner Indus., Inc.*, 10 Bankr. 711, 714 (Bankr. C.D. Cal. 1981) (offer of interest converted to compensation of depreciation); *In re Kleinsasser*, 12 Bankr. 452, 455 (Bankr. D.S.D. 1981) (not entitled to interest); *In re Wheeler*, 12 Bankr. 908, 910 (Bankr. D. Mass. 1981) (debtor maintained contract payments); *In re 5-Leaf Clover Corp.*, 6 Bankr. 463, 467-68 (Bankr. S.D. W. Va. 1980).

71. See *In re Kleinsasser*, 12 Bankr. 452, 453-55 (Bankr. D.S.D. 1981); *In re American Mariner Indus., Inc.*, 10 Bankr. 711, 713 (Bankr. C.D. Cal. 1981).

72. *Bankruptcy Reform Act: Hearings on S. 235 and S. 236 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, pt. 2, 94th Cong., 1st Sess. 522 (1976) (statement of Carroll G. Moore, Chairman, Comm. on Legislation, Nat'l Com. Fin. Conf.).

73. See, e.g., *In re Alycan Interstate Corp.*, 12 Bankr. 803 (Bankr. D. Utah 1981). See also *infra* text accompanying notes 150-71.

74. See 11 U.S.C. § 506(b) (Supp. V 1981). See also O'Toole, *supra* note 44,

volve an existing cushion, there is little indication that the absence of a cushion makes removal of the stay more likely. This may be due to a reduced impetus to protect opportunity cost in equipment cases because they typically involve smaller values. Alternatively, it may relate to the nature of the initiating transaction. Real estate creditors are often able to insist upon and retain a cushion to ensure full recovery, whereas equipment lenders are typically unable to do so after initial depreciation occurs. The differential analysis may also reflect a judgment that a cushion is a basic element of normal real estate loans, but not equipment loans.⁷⁵

3. Behavioral Factors

Although financial protections are quite limited in an equipment setting, the reported cases do not involve a one-dimensional comparison of depreciation to protection offered. Rather, assuming core protection exists, courts in these cases are influenced by a variety of factors related primarily to the behavior and prospects of the debtor. These factors determine the circumstances in which the equities justify retention of the stay to allow the debtor an opportunity to reorganize.

In part, these factors relate to the debtor's general conduct toward the creditor and the collateral, both prior to the filing and during bankruptcy. In a general equitable analysis of the respective rights of the parties, the expectation is that the debtor has dealt with the creditor fairly and in good faith. Unlike cases involving other forms of collateral,⁷⁶ none of the equipment cases involve instances of apparent pre-bankruptcy fraud or overreaching. In several cases, however, good faith pre-bankruptcy efforts to repay the outstanding debt worked to the advantage of the debtor. For instance, in *In re Wheeler*,⁷⁷ the court's willingness to retain a stay was linked in part to the debtor's prior good record of making payments on the loan, coupled with a willingness to continue full payments after filing.⁷⁸

at 271 (comparing cases supporting and undermining the validity of equity cushion analysis).

75. See Nimmer, *supra* note 7, at —.

76. See, e.g., *In re Andrews*, 17 Bankr. 515, 519 (Bankr. C.D. Cal. 1982); *In re Zed, Inc.*, 20 Bankr. 462, 464 (Bankr. N.D. Cal. 1982); *In re Victory Constr. Co.*, 9 Bankr. 549, 564 (Bankr. C.D. Cal. 1981); *In re Anchorage Boat Sales, Inc.*, 4 Bankr. 635, 637 (Bankr. E.D.N.Y. 1980).

77. 12 Bankr. 908 (Bankr. D. Mass. 1981).

78. But see *In re Penn York Mfg., Inc.*, 14 Bankr. 51, 52 (Bankr. M.D. Pa. 1981) (stay terminated where debtor had made no payments on debt).

The advantage to the debtor of good faith dealing with the creditor continues into the post-filing context. Significantly, a majority of the cases in which the stay was retained involved prehearing offers by the debtor to make periodic, compensatory payments to the creditor.⁷⁹ In contrast, such offers were infrequent in reported cases in which the stay was terminated.⁸⁰ In one such case, the offer to pay followed more than one year of nonpayment.⁸¹

In part, this pattern is related to the judicial role in adequate protection cases. In contrast to prior law, the legislative history of the Code indicates that courts have no obligation to supply adequate protection, but need only evaluate the debtor's proposals.⁸² Thus, where depreciation is proved, termination of the stay is appropriate if the debtor makes no proposal. A number of courts, however, have been willing to undertake an active role and specify terms of protection.⁸³ The pattern is also connected to traditional equitable concepts, which should favor debtors who can establish a good faith effort to protect creditors' interests.

Beyond the debtor's protective efforts, courts are also influenced by factors related to the need for retaining the stay and the feasibility of reorganization efforts.⁸⁴ One such factor is the

79. See, e.g., *In re A & A Transport, Inc.*, 10 Bankr. 867, 870 (Bankr. D. Mass. 1981); *In re Kleinsasser*, 12 Bankr. 452, 453 (Bankr. D.S.D. 1981); *In re Wheeler*, 12 Bankr. 908, 910 (Bankr. D. Mass. 1981). But see *In re Champion Coal Co.*, 21 Bankr. 733, 735-36 (Bankr. W.D. Pa. 1982) (offer inadequate).

80. See, e.g., *In re Farina*, 9 Bankr. 726 (Bankr. D. Me. 1981); *In re Hanson Dredging, Inc.*, 6 Bankr. 230 (Bankr. S.D. Fla. 1980).

81. See *In re Penn York Mfg., Inc.*, 14 Bankr. 51, 52-53 (Bankr. M.D. Pa. 1981).

82. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 338, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 6295 ("This section does not require the court to provide [adequate protection]. To do so would place the court in an administrative role.").

83. See, e.g., *In re Certified Mortgage Corp.*, 19 Bankr. 369, 371 (Bankr. M.D. Fla. 1982); *In re Coors of the Cumberland, Inc.*, 19 Bankr. 313, 321-22 (Bankr. M.D. Tenn. 1982); *In re 5-Leaf Clover Corp.*, 6 Bankr. 463, 468 (Bankr. S.D. W. Va. 1980); *In re Pleasant Valley, Inc.*, 6 Bankr. 13, 17-18 (Bankr. D. Nev. 1980).

This pattern, however, is not universally followed. In some cases, courts expressly refuse to fashion means of adequate protection where none are proposed by the debtor. See, e.g., *In re Ocean State Optical Co.*, 22 Bankr. 893, 895 (Bankr. D.R.I. 1982). One court has suggested that the willingness to structure an adequate protection order arises from the informality of the proceedings and the statutory mandate that the court either terminate or *modify* the stay when confronted with inadequate protection. See *In re Alyucan Interstate Corp.*, 12 Bankr. 803, 809 n.12 (Bankr. D. Utah 1981). Orders specifying the terms of adequate protection take the form of modifications conditioning continuation of the stay on compliance with the stated terms.

84. But see 11 U.S.C. § 362(d)(2) (Supp. V 1981) (requiring relief from the

timing of the request for relief from the stay. In general terms, the debtor's ability to retain the stay is strongest during the earliest stages of the case.⁸⁵ At this point, the desirability of creating at least an opportunity to reorganize is strongest, and it may be "premature" to take action that may effectively terminate the case.⁸⁶ In contrast, after a more substantial period of time, the purposes of the stay may have been served and the creditor's interests may become dominant.⁸⁷ Predictably, no firm time standards apply. Instead, there are contextual variations based on the complexity of the case, the efforts toward reorganization, and whether a reorganization plan has been proposed.

Closely connected to the timing of the request for relief from the stay is a court's assessment of the feasibility of eventual reorganization. In equipment cases, this assessment is typically not contingent on proof of current profitability, although the existence of a current net profit inclines toward retaining the stay.⁸⁸ Nor does the assessment commonly involve a close analysis of markets. Rather, courts typically examine feasibility in prospective, generalized terms, focusing on the existence of continuing business activities and some affirmative effort by the debtor to restructure or streamline operations.⁸⁹ A corollary of this analysis weighs the equities against the debtor where business operations have effectively terminated or where there is doubt about the debtor's willingness or ability to operate a business.⁹⁰ For example, in *In re Hanson Dredging, Inc.*,⁹¹ the court based its termination of a stay against repossession of dredging equipment in part on a finding that the equipment had not been used for over one year.⁹² Such circumstances obviously bear upon both the debtor's need for the property and the feasibility of its reorganization effort.

stay if there is no equity remaining in the debtor and the property is not *necessary* to an *effective* reorganization).

85. *But see* Nimmer, *supra* note 7, at —.

86. *See In re Classic Printers, Inc.*, 24 Bankr. 24, 25 (Bankr. S.D. Fla. 1982).

87. *See In re Urban Indus., Inc.*, 22 Bankr. 975, 977 (Bankr. E.D. Pa. 1982); *In re Penn York Mfg., Inc.*, 14 Bankr. 51, 53 (Bankr. M.D. Pa. 1981).

88. *See, e.g., In re American Mariner Indus., Inc.*, 10 Bankr. 711, 712 (Bankr. C.D. Cal. 1981); *In re Xinde Int'l, Inc.*, 13 Bankr. 212, 215 (Bankr. D. Mass. 1981).

89. *See In re Coors of the Cumberland, Inc.*, 19 Bankr. 313, 319 (Bankr. M.D. Tenn. 1982).

90. *See In re Paradise Boat Leasing Corp.*, 2 Bankr. 482, 484 (Bankr. D.V.I. 1979).

91. 6 Bankr. 230 (Bankr. S.D. Fla. 1980).

92. *Id.* at 231.

B. FLOATING COLLATERAL

In contrast to equipment financing, secured lending with respect to "floating collateral" is a relatively high risk, high return undertaking. "Floating collateral," for the purposes of this Article, consists of property that is expected to be sold or otherwise dissipated over a relatively brief time interval. It encompasses the U.C.C. categories of "inventory" and "accounts."⁹³ Secured transactions involving floating collateral follow a variety of formats. In some cases, the loan is made in one or a few installments with a pool of floating collateral as security and a fixed repayment schedule. More commonly, however, the loan consists of multiple advances keyed to the acquisition of property, with payments to the creditor at least partially dependent on the sale or other disposition of the property. The loan obligation may be expressed in terms of a maximum aggregate indebtedness secured by property of a specified aggregate value.

Under any of its manifestations, floating lien financing is particularly dependent on the debtor's good faith and current profitability. Both parties to such transactions contemplate from the outset that the collateral pool will be in continual flux due to sales and acquisitions. In many instances, the creditor's profit from the loan is substantially dependent on access to proceeds of sales. In any event, the creditor's position may be substantially affected by misjudgments or misrepresentations of acquisitions or sales. Consequently, most floating lien transactions impose restrictive reporting obligations or inspection rights. Significant changes, however, may occur over short periods and remain undetected.

1. Core Protection

As with equipment, the central issue in floating lien cases typically involves protection of recoverable value, rather than establishment of basic need. Depreciation is seldom an issue.⁹⁴ The closest approximation to depreciation is more appropriately characterized as "actual value revealed." For example, the market value of inventory not sold after a certain period may decline significantly. Similarly, accounts not collected after a given time may be revealed as uncollectible. Neither ex-

93. U.C.C. § 9-109(4) (1978).

94. Issues related to depreciation do arise in connection with items leased on a periodic basis to third parties. See, e.g., *In re Nixon Mach. Co.*, 9 Bankr. 316, 318 (Bankr. E.D. Tenn. 1981); *In re Kenny Kar Leasing, Inc.*, 5 Bankr. 304, 309 (Bankr. C.D. Cal. 1980).

ample, however, typically represents a loss in recoverable value attributable to a stay against creditor action.

The primary threat to recoverable value in floating collateral cases involves dissipation or consumption of the property, such as the sale of an item of inventory or the collection of an account. Typically, the creditor's lien transfers to the proceeds of these dispositions of the collateral. If the proceeds are cash, however, the creditor's interest is subject to extinction if the cash is commingled or used for operational purposes. Absent affirmative action by the parties or the court, the security interest does not extend to inventory or accounts acquired after the bankruptcy filing.⁹⁵

The extreme volatility of floating collateral defines a basic element of the risk in this form of financing. The risk that the creditor's position is subject to rapid change is recognized by the Code. An early draft of the Code contained a provision precluding the use or sale of "soft collateral" without prior court authorization, or consent of the secured creditor.⁹⁶ "Soft collateral" included inventory, accounts, and cash. The provision was intended to safeguard the creditor against rapid, post-filing changes in the debtor's position until judicial protection could be implemented. Because this broad provision could have substantially and excessively disrupted the debtor's post-petition business operation, the final form of the Code was modified to permit debtors to use inventory and accounts in the ordinary course of business without a court order, but also to require authorization or consent for the use of "cash collateral."⁹⁷ The effect of this provision has been to force very early decisions on use of cash collateral in inventory cases.⁹⁸ Generally, at least in the reported cases, courts have authorized use of cash collateral subject to various restrictions.

In the typical case, the core elements of adequate protection cannot be provided through cash payments. For example, in an inventory case, the proceeds of sales of inventory represent the primary cash flow to support business operations. Particularly where the cash position of the debtor consists almost entirely of cash from encumbered inventory, a protective order turning these proceeds over to the creditor in one-for-one com-

95. See 11 U.S.C. § 552 (Supp. V 1981). See also *In re Karl A. Niese, Inc.*, 16 Bankr. 600, 602 (Bankr. S.D. Fla. 1981).

96. See S. REP. NO. 989, 95th Cong., 2d Sess. 55, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5841.

97. See 11 U.S.C. § 363(c)(1) (Supp. V 1981).

98. See *infra* text accompanying notes 136-42.

pensation for loss would eventually close down the business. Although cash payments are commonly required in inventory cases, they serve other functions and are not calibrated to compensate for lost value due to sale.

Instead, the primary method of preserving the creditor's value position involves the imposition of replenishment requirements. For example, in *In re Karl A. Niese, Inc.*,⁹⁹ the net value of inventory was increasing due to the use of unencumbered cash for purchases. The court found adequate protection in the form of a security interest in the newly acquired inventory.¹⁰⁰ Similarly, in several cases adequate protection orders contain requirements that the debtor maintain inventory or accounts at a specified value level.¹⁰¹ This form of protection tracks the character of the underlying transaction. The floating lien creditor does not typically rely on a single item of property, but relies instead on an aggregate pool of property that, almost by definition, is constantly changing as to particular items. In bankruptcy, however, this form of protection often requires an express grant of a replacement lien on subsequently-acquired property, since the Code provides that the typical after-acquired property clause in an inventory agreement is ineffective after filing.¹⁰² In the absence of an express grant, the creditor has no claim to this property unless it can be established that the new items are proceeds of the original collateral.

As to basic protections, a similar pattern prevails in cases involving the use of cash proceeds derived from the sale of encumbered inventory or collection of encumbered accounts. In cases in which the debtor is able to pay operating expenses from unencumbered property, no particular difficulty arises. Depending on the debtor's sales volume and profit margin, the creditor receives core protection if the proceeds are used to obtain replacement property in equivalent or greater amounts.¹⁰³ More typically, however, the entire inventory is encumbered and a portion of the cash proceeds must be used to cover basic operating expenses. In such situations, the initial reaction is that the creditor's net position will decline. Such decline, however, is not inevitable.

99. 16 Bankr. 600 (Bankr. S.D. Fla. 1981).

100. *Id.* at 601-02.

101. See *In re Greenwood Bldg. Supply, Inc.*, 23 Bankr. 720, 722 (Bankr. W.D. Mo. 1982); *In re Potvin Lumber Co.*, 24 Bankr. 54, 56 (Bankr. D. Vt. 1982).

102. See 11 U.S.C. § 552 (Supp. V 1981).

103. See *In re Charay Indus., Inc.*, 23 Bankr. 988, 997 (Bankr. E.D. Mich. 1982).

An illustration of this circumstance arose in *In re Jim Kelly Ford, Ltd.*,¹⁰⁴ where the creditor was secured by an interest in inventory and in a cash account. The issue was whether the debtor could withdraw funds from the account to cover necessary operating expenses. The lower court permitted the debtor to use the funds, concluding that the creditor would receive a net benefit from the resulting ordinary course sales because of the debtor's ability to cover operating expenses.¹⁰⁵ The district court affirmed this conclusion, holding that the creditor could be adequately protected by the anticipated gain from the sales, even though there was no anticipated net profit. The court explained the financial aspect of its decision as follows:

[The] assets in which Ford Credit had a security interest before Judge Eisen's order comprised the Fund and the automobile inventory, the latter having a value equal to 75% of Kelly Ford's cost. So long as the diminution in the value of the Fund . . . is matched by an enhancement in the value of the other asset—that is by an increase in the realization from sales of the automobile inventory over the 75% figure—Ford will have received "adequate protection" in the form of the "indubitable equivalent" called for by the Code.¹⁰⁶

As the court's analysis suggests, adequate protection of a current cash fund is commonly not viewed in isolation from other collateral, at least not in a floating collateral context. Rather, the interaction between the various forms of collateral, such as inventory, accounts, and cash, is recognized. If the creditor's interest encompasses several different accounts, the net change over all collateral is the relevant issue, rather than the change in one particular pool of assets.

Although this form of core protection is conceptually sound, it entails substantially greater risk than is involved in equipment cases, especially where the proceeds of the collateral are used in part to pay the debtor's operational expenses. For example, in order to find adequate core protection, the court in *Jim Kelly Ford* had to determine that the projected retail sale price (ninety-three percent of cost) sufficiently exceeded the current value of the collateral (seventy-five percent of cost) to cover the costs of operation.¹⁰⁷ Similar projections are common in floating lien cases, including those that involve direct replacement of inventory as it is sold.¹⁰⁸ These projec-

104. 14 Bankr. 812 (N.D. Ill. 1980).

105. *Id.* at 815.

106. *Id.* at 818 n.3.

107. *See id.* at 818.

108. The risk is less extreme where inventory is being replenished in part by supplemental funds from the debtor, or where the proceeds of sale are not used to finance operations. *See, e.g., In re Charay Indus., Inc.*, 23 Bankr. 988, 997

tions and estimations are contingent on a number of market factors and are subject to significant error that might be detrimental to the creditor's position. Such risks are, of course, inherent in the nature of the original loan transaction. Extending these risks into the bankruptcy context is essential to ensure the debtor an opportunity to reorganize, and is justified by the character of the risk that the creditor originally assumed outside of bankruptcy.

2. Reconstructing the Bargain

As previously indicated, judicial efforts to reconstruct the original bargain in equipment cases are substantially limited; adequate protection in financial terms involves little more than core compensation for depreciation of property value. In contrast, floating collateral cases routinely involve substantial reconstruction of the original bargain, due in large part to a general tendency on the part of courts to compensate for the extra risk encountered by the creditor. Compensation commonly includes payment of interest on the enforced investment and maintenance of at least some cash flow to the creditor. Although not necessarily required by the statutory emphasis on *protection*, this greater emphasis on reconstructing the original bargain is justified by the substantial risks to the creditor.

Consideration of judicial reconstruction of floating lien bargains requires an initial concentration on issues of collateral valuation. The typical inventory finance arrangement illustrates that a single item of property may have several values depending on the market in which sale is anticipated. For purposes of this discussion, it will be sufficient to focus on three alternative measures: liquidation value (forced sale price), wholesale value, and retail value. In a normal retail operation, the debtor-merchant derives its profit from the difference between its cost (usually wholesale value) and the price at which it sells the property (usually retail value), minus any overhead, operating, or financing costs. Similarly, the creditor's profit and secured position will be derived largely from this same differential, especially where the creditor is financing the entire inventory of the debtor. The property is typically financed at a percentage of the dealer's acquisition cost and payments are based on a schedule related to retail operations. In essence, the transaction is a contingent joint venture in which the posi-

(Bankr. E.D. Mich. 1982); *In re Karl A. Niese, Inc.*, 16 Bankr. 600, 601 (Bankr. S.D. Fla. 1981).

tion of both parties is affected by the debtor's current ability to sell at a profit.¹⁰⁹

In bankruptcy, this transactional form creates significant conceptual problems in deriving a standard of valuation to be applied to the inventory in any particular context. The Code expressly declines to resolve this question through a uniform rule. Instead, section 506 of the Code merely provides that property valuation is to be made in light of the "purpose of the valuation and the proposed disposition or use of such property."¹¹⁰ A valuation standard used for one purpose need not necessarily control subsequent valuations made for different purposes. This statutory language provides inadequate guidance. In the typical inventory case the debtor proposes to dispose of the property at retail or wholesale prices. In contrast, if allowed to foreclose, the creditor will commonly dispose of the property wholesale or through a liquidation auction. Depending on the market and the type of collateral, the difference between liquidation and retail value may be as high as two-hundred percent, even assuming commercially reasonable behavior.

This differential has led to substantial controversy. An earlier draft of the Bankruptcy Code proposed uniform use of liquidation value with reference to automatic stay issues.¹¹¹ This proposal was rejected, however, and replaced by the language in section 506(a) quoted above. The congressional reports indicate that the choice of a valuation standard should be made on a case-by-case basis:

[It is not] expected that the courts will construe the term value to mean, in every case, forced sale liquidation value or full going concern value In any particular case, especially a reorganization case, the determination of which entity should be entitled to the difference between the going concern value and the liquidation value must be based on equitable considerations based on the facts of the case.¹¹²

Predictably, the creditor community is strongly supportive of a going concern or retail valuation of inventory.¹¹³ Doctrinal support for this position derives largely from the pre-Code, inventory case of *In re American Kitchen Foods, Inc.*,¹¹⁴ in which the

109. As will be discussed below, this relationship leads to an emphasis on current profitability in floating lien cases. See *infra* text accompanying notes 142-48.

110. 11 U.S.C. § 506(a) (Supp. V 1981).

111. See COMMISSION REPORT, *supra* note 28, pt. II, at 237.

112. H.R. REP. NO. 595, 95th Cong., 1st Sess. 339, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 6295.

113. See Murphy, *supra* note 31, at 1509.

114. 2 BANKR. CT. DEC. (CRR) 715 (Bankr. D. Me. 1976).

court purported to rely on U.C.C. default provisions to resolve the disparity between the value of the property to the debtor based on its proposed use and the value of the property to the creditor based on its most likely sale. The U.C.C. requires that foreclosure sales be conducted in a commercially reasonable manner.¹¹⁵ The court contrasted this standard to liquidation sales and concluded that not only was a liquidation standard inappropriate, but the appropriate standard should reflect the *most commercially reasonable sale*:

Where the collateral is used or produced . . . by a going business which offers reasonable prospects that it can continue, the value of the collateral is equatable with the net recovery realizable from its disposition as near as may be in the ordinary course of business. . . .

[Conversion] in the ordinary course of business should be considered the most commercially reasonable disposition, simply because and to the extent that it is more productive.¹¹⁶

At least one court has applied a retail valuation in automatic stay litigation in accord with this reasoning.¹¹⁷

American Kitchen Foods represents an interesting inversion of the U.C.C. standard. The U.C.C. provision establishes a minimum standard of fair conduct by creditors in order to protect debtors against unreasonably low sales of property after foreclosure.¹¹⁸ *American Kitchen Foods*, however, inverts this standard, establishing criteria that presume a maximal effort, resulting in a valuation standard that substantially restricts debtors and benefits creditors. Under a retail valuation, the debtor, unless buttressed by substantial cash reserves, is exposed to risk of loss of the collateral due to unavoidable and unexpected declines in the *retail* market for the current inventory.

A more basic flaw in applying a retail valuation standard (or the equivalent if the debtor is a wholesaler) is that the standard fails to reflect the actual basis on which the transaction was built. In most cases, a lender secured by floating collateral does not advance money based on the anticipated retail sale price. Rather, such loans are normally based on discounts from the debtor's acquisition cost. Wholesale valuation is implicit in a transaction that depends on profit margin to generate income for both parties. Where it forms the underlying basis of

115. See U.C.C. § 9-504 (1978).

116. *American Kitchen Foods, Inc.*, 2 BANKR. CT. DEC. (CRR) at 721-22.

117. See *In re QPL Components*, 20 Bankr. 342, 346 (Bankr. E.D.N.Y. 1982).

118. See generally Hogan, *The Secured Party and Default Proceedings Under the UCC*, 47 MINN. L. REV. 205, 220-29 (1962); Comment, *Commercial Reasonableness Under the Uniform Commercial Code*, 33 TENN. L. REV. 211 (1965).

the transaction, wholesale valuation should be used to determine adequate protection:

Going concern value does not mean that in eschewing liquidation value one must rely upon retail prices rather than wholesale prices. Surely an institutional financier of automobiles at 100% of the wholesale cost should be entitled to rely upon the wholesale prices of the vehicles since the secured creditor is not in the business of retailing the vehicles and is not expected to derive full retail value upon foreclosure.¹¹⁹

Utilization of a wholesale valuation standard results in a reconstructed bargain that approximates the original agreement. Obviously, the total of all collateral, including cash, accounts, and inventory, will fluctuate as "wholesale" property is sold at "retail" prices and operating expenses or replacement costs are paid. This fluctuation does not necessarily impede protection of the creditor's initial position, however, and is bargained for by the parties.

Regardless of the valuation standard, the crux of a floating lien transaction consists of the difference between the costs of acquisition and sale, and the price or value received. This profit margin has obvious significance to both the debtor and the creditor. It is obtained, however, at a significant risk to the creditor in both the initiating transaction and the adequate protection context. Based substantially on this risk element, courts generally do not restrict the creditor's adequate protection to merely a projected maintenance of the status quo. Instead, courts compensate the creditor for this inherent risk by at least partial reimbursement of opportunity cost, and by a requirement that the debtor maintain a cash flow of payments or other value transfers to the creditor as a condition for retaining the stay.

Although the view that floating lien cases require a more complete reconstruction of the creditor's bargain is virtually universally held, it is generally implicit in the court's approach to the case, rather than explicitly stated in terms of a doctrinal holding that inventory cases should be handled differently than equipment cases.¹²⁰ Some form of payment to the creditor is

119. *In re Thomas Parker Enters., Inc.*, 10 Bankr. 783, 788 (Bankr. D. Conn. 1981). See also *In re Jim Kelly Ford, Ltd.*, 14 Bankr. 812, 818 (N.D. Ill. 1980).

120. Notably, two of the cases often cited for the premise that interest payments are required for adequate protection arose in a floating lien context. See *In re Virginia Foundry Co.*, 9 Bankr. 493 (W.D. Va. 1981); *In re Anchorage Boat Sales, Inc.*, 4 Bankr. 635 (Bankr. E.D.N.Y. 1980). None of the floating lien cases expressly reject the inclusion of interest within adequate protection. In contrast, a major case rejecting interest as an element of protection arose in an equipment context. See *In re American Mariner Indus., Inc.*, 10 Bankr. 711, 712-13 (Bankr. C.D. Cal. 1981). Arguably, although courts state their respective con-

required in roughly seventy-five percent of the floating lien cases in which the stay is retained. These payments are generally not designed to offset anticipated reductions in collateral value. The payments are typically coupled with a requirement that the debtor maintain a stable aggregate inventory value.¹²¹ Where payments are not required, the stay is generally retained only upon a showing that the creditor's position is likely to *improve* through continued "use" of the inventory—another example of profit compensating for risk.¹²² Similarly, in cases in which the stay is vacated, the common fact pattern is that no payments are offered to the creditor and no vehicle exists to establish that the creditor will profit from the operations of the debtor.¹²³ For example, in *In re Thomas Parker Enterprises, Inc.*,¹²⁴ the court vacated the stay in part because the debtor was unable to offset accruing interest on the claim. Post-petition interest was not required under the Code, however, since there was no excess collateral value.

In the context of inventory or accounts, the requirement of periodic transfers to the creditor is independent of the availability of an equity cushion to protect the creditor's initial position during the early stages of the case. For example, in *In re Earth Lite, Inc.*,¹²⁵ the court required payments although the collateral substantially exceeded the outstanding balance of the claim. For several months after filing, the debtor had used cash, inventory, and accounts under a post-filing agreement requiring the debtor to make periodic cash payments on principal and interest. When the debtor defaulted on this agreement, the creditor sought to enjoin the debtor's continued use of the property. The debtor argued that the creditor was adequately protected as a result of a substantial "equity cushion" which would protect the creditor's secured position notwithstanding

clusions in general terms, the doctrinal result in these cases is conditioned by the type of collateral involved. The cases involving real estate split on this issue. Compare *In re Monroe Park*, 17 Bankr. 934, 941 (D. Del. 1982) (interest award appropriate) with *In re South Village, Inc.*, 25 Bankr. 987, 990 (Bankr. D. Utah 1982) (mortgagee not entitled to interest).

121. See, e.g., *In re Greenwood Bldg. Supply, Inc.*, 23 Bankr. 720, 722 (Bankr. W.D. Mo. 1982); *In re Heatron, Inc.*, 6 Bankr. 493, 497 (Bankr. W.D. Mo. 1980).

122. See *In re Karl A. Niese, Inc.*, 16 Bankr. 600, 602 (Bankr. S.D. Fla. 1981); *In re Jim Kelly Ford, Ltd.*, 14 Bankr. 812 (N.D. Ill. 1980). But see *In re Sel-O-Rak Corp.*, 24 Bankr. 5 (Bankr. S.D. Fla. 1982).

123. See *In re Ocean State Optical Co.*, 22 Bankr. 893, 895 (Bankr. D.R.I. 1982); *In re Anchorage Boat Sales, Inc.*, 4 Bankr. 635, 642-43 (Bankr. E.D.N.Y. 1980).

124. 10 Bankr. 783 (Bankr. D. Conn. 1981).

125. 9 Bankr. 440 (Bankr. M.D. Fla. 1981).

some decrease in property value.¹²⁶ Focusing on the cash collateral, the court rejected this claim and ordered the debtor to resume monthly payments:

[The] Debtor should not be permitted to use cash collateral without making some payments to the secured party just because it has . . . a meaningful equity cushion in the collateral. To accept this proposition would mean that a debtor may freely use cash collateral until the collateral is reduced to the amount of indebtedness during which time the secured party is deprived of income, for which it bargained when the loan was granted.¹²⁷

Thus, the requirement of periodic payments is not tied to or delimited by a net reduction in the value of the collateral. Indeed, in *Earth Lite*, the payments had resulted in a substantial reduction of the outstanding claim with no proven reduction in collateral.

The requirement of payments and compensation for interest can be viewed as compensation for, *and profit from*, the substantial risk the creditor undertook and continues to assume. In this manner, courts are making extensive efforts to reconstruct the full value of the original agreement. In a typical floating lien agreement, there is a continuing interaction between disbursements and payments. In bankruptcy, the disbursements have terminated, except insofar as the debtor has the right to sell inventory and retain the proceeds.¹²⁸ The exercise of that right by the debtor and the risk it entails justify compensation analogous to that bargained for in the original agreement. In cases where payments are required, the computational formula varies. Often, the debtor is required to make periodic payments in specified amounts directly linked to agreements encompassing repayment of both principal and interest.¹²⁹ In other cases, the debtor must pay the creditor a percentage of proceeds.¹³⁰ In all cases, however, the assumption is that the creditor has a right to participate in the profit realized by use of its collateral.

In addition to cash payments, courts generally impose additional restraints on the debtor in order to provide protection. For instance, the debtor may be required to make periodic reports summarizing property and cash flow attributable to con-

126. *Id.* at 443.

127. *Id.* at 444.

128. See 11 U.S.C. § 363(c)(1) (Supp. V 1981).

129. See, e.g., *In re Earth Lite, Inc.*, 9 Bankr. 440, 444 (Bankr. M.D. Fla. 1981); *In re Anderson-Walker Indus., Inc.*, 3 Bankr. 551, 552 (Bankr. C.D. Cal. 1980); *In re Heatron, Inc.*, 6 Bankr. 493, 497 (Bankr. W.D. Mo. 1980).

130. See *In re QPL Components, Inc.*, 20 Bankr. 342, 346 (Bankr. E.D.N.Y. 1982); *In re Cormarc, Inc.*, 16 Bankr. 551, 553 (Bankr. S.D. Fla. 1981).

tinued use of the collateral.¹³¹ This report and monitoring requirement directly tracks a common element of inventory financing and represents yet another aspect of reconstructing the original bargain. Due to the rapid conversion of individual items, a process of reporting and inspection is integral to ensuring maintenance of the creditor's actual position.

3. Behavioral Factors

As the foregoing discussion indicates, courts require the creditor to retain relatively substantial risks inherent in transactions in which floating collateral is utilized, but compensate for such risks by establishing relatively elaborate protective constraints that substantially reconstruct the original bargain. Within this context, many of the reported cases might be described as being resolved solely within the parameters of financial protections. Actually, however, as in equipment cases, behavioral, timing, and operational considerations also have a significant role.

These factors are analogous to those noted with reference to equipment lenders. For example, demonstrable efforts to protect the creditor's position and repay the debt tend to augment the debtor's position in automatic stay cases. This is true whether the efforts occur before or after the bankruptcy filing.¹³² In contrast, if the debtor displays apparent indifference to the creditor's interests, courts tend toward vacating the stay without any effort to interpose orders requiring protection.¹³³

One pattern that is not encountered in the equipment setting involves debtor misconduct with respect to the loan collateral and collections. As noted previously, in a floating lien arrangement in which the creditor makes advances based on new acquisitions and receives payments upon sales, substantial reliance is placed on accurate reporting and monitoring of inventory transactions. In some cases, through negligence or fraud, inaccurate data can lead to the creditor's position being

131. See, e.g., *In re Potvin Lumber Co.*, 24 Bankr. 54, 56 (Bankr. D. Vt. 1982); *In re Heatron, Inc.*, 6 Bankr. 493, 496-97 (Bankr. W.D. Mo. 1980).

132. See *In re Earth Lite, Inc.*, 9 Bankr. 440, 441 (Bankr. M.D. Fla. 1981) (post-petition agreement reducing debt); *In re Karl A. Niese, Inc.*, 16 Bankr. 600, 601 (Bankr. S.D. Fla. 1981) (post-petition use of cash to increase inventory); *In re Anderson-Walker Indus., Inc.*, 3 Bankr. 551, 552 (Bankr. C.D. Cal. 1980) (offer to make note payments).

133. See, e.g., *In re Ocean State Optical Co.*, 22 Bankr. 893, 895 (Bankr. D.R.I. 1982).

substantially changed without the creditor's knowledge. When this occurs prior to or during a bankruptcy case, it has an obvious impact on the debtor, who is essentially arguing for an equitable right to retain the property and continue to expose the creditor to risk. The debtor's position was accurately described by the court in *In re Lackow Brothers, Inc.*:¹³⁴

[The] Court's decision is also influenced by evidence of misconduct on the part of the Debtor which was tantamount to fraud and which resulted in substantial injury to [the creditor]. Briefly, it appears that the Debtor induced [the creditor] to advance moneys . . . based on a representation that . . . goods had been shipped . . . when most of the goods had not in fact been shipped

Suffice to say, in view of the Debtor's history of misconduct and flagrant violation of rights conferred on [the creditor] by its security agreements, an arrangement whereby the Debtor obtained unfettered use of any portion of its inventory or accounts receivable pledged to [the creditor] could not fairly be said to afford [the creditor] adequate protection.¹³⁵

In the absence of an operational management change,¹³⁶ the impact of misconduct is apparent. The debtor claims an equitable right to retain the property and continue in business. To qualify for this right, the debtor must at least have acted in good faith toward the creditor. In the presence of fraudulent misconduct, the creditor's risk escalates and the equitable right evaporates.

Although allegations of misconduct arise in the floating lien context, in most cases there has been no provable fraud. In such instances, courts are responsive to less dramatic aspects of the factual context. With respect to these factors, however, characteristics of the transaction and of the Code alter the emphasis applied in floating collateral cases.

An initial consideration is the stage in the case at which the adequate protection issue is raised. As in equipment cases, the debtor's position weakens as the proceeding matures. In floating lien cases, however, the timing is substantially truncated by a Code provision that prohibits the use of cash collateral without court authorization.¹³⁷ When coupled with an understandable desire by creditors to obtain early protection of, or access to, volatile property, this provision forces critical decisions on inventory, accounts, and cash into very early

134. 10 Bankr. 717 (Bankr. S.D. Fla. 1981).

135. *Id.* at 720. See also *In re Anchorage Boat Sales, Inc.*, 4 Bankr. 635, 640 (Bankr. E.D.N.Y. 1980).

136. See, e.g., *In re QPL Components, Inc.*, 20 Bankr. 342, 345 (Bankr. E.D.N.Y. 1982).

137. See 11 U.S.C. § 363(c)(2) (Supp. V 1981).

stages of the proceeding. In most of the reported decisions, courts ruled on this issue within seven months of the filing of the petition. In a majority of cases, a ruling was made within three months.¹³⁸

This pattern is most pronounced in cases dealing with the use of cash collateral, where it is not uncommon for a court to reach a decision on at least a preliminary basis within days of the filing.¹³⁹ Such promptness benefits the creditor to the extent that it imposes protective review very early in the process, but it also inclines the court toward decisions that at least temporarily allow the debtor to use the collateral and remain in operation.

The court's analysis in *In re Heatron, Inc.*¹⁴⁰ illustrates the influence of this truncated time frame. In *Heatron*, a decision on the use of cash collateral was rendered approximately one month after the petition was filed. The court acknowledged that there was "no question" that use of the cash was essential for the debtor to continue doing business.¹⁴¹ While the debtor argued that adequate protection could be found in excess collateral value and anticipated replenishment, there was considerable dispute as to the amount and value of the collateral, as well as to the debtor's business prospects. Faced with these disputes, the court allowed the debtor to use the cash, reasoning:

The Court is not obligated to protect the creditor better than it did itself when making the loan and obtaining security. At the same time, the Court cannot allow the security to be diminished. The policy of the Code . . . is to encourage reorganization if there is a reasonable possibility of success. At the beginning of the reorganization process, the Court must work with less evidence than might be desirable and should resolve issues in favor of the reorganization, where the evidence is conflicting.

Here, while there are disputes as to the value of the security, [there are] values in excess of the debt, although not . . . a comfortable amount. It is incumbent upon the Court, therefore, to make specific requirements . . . to insure . . . adequate protection.¹⁴²

138. See, e.g., *In re QPL Components, Inc.*, 20 Bankr. 342 (Bankr. E.D.N.Y. 1982); *In re Thomas Parker Enters., Inc.*, 10 Bankr. 783 (Bankr. D. Conn. 1981); *In re Anchorage Boat Sales, Inc.*, 4 Bankr. 635 (Bankr. E.D.N.Y. 1980).

139. See *In re Sel-O-Rak Corp.*, 24 Bankr. 5, 5 (Bankr. S.D. Fla. 1982) (two weeks); *In re Anderson-Walker Indus., Inc.*, 3 Bankr. 551, 552 (Bankr. C.D. Cal. 1980) (one week); *In re Heatron, Inc.*, 6 Bankr. 493, 495 (Bankr. W.D. Mo. 1980) (one month).

140. 6 Bankr. 493 (Bankr. W.D. Mo. 1980).

141. *Id.* at 495.

142. *Id.* at 496 (citations omitted). In the absence of adequate protective efforts, however, there is no statutory or equitable right to a "breathing spell." *In re Ocean State Optical Co.*, 22 Bankr. 893, 895 (Bankr. D.R.I. 1982). But see *In re*

The court required weekly reports, monthly proof that inventory was being replenished, and weekly payments of principal and interest.¹⁴³

The dilemma noted in *Heatron* arises in all similar cases where the court reaches an early decision. The basic policies of section 362 and Chapter 11 indicate that a business debtor should have an opportunity to reorganize. An early, negative decision on use of the collateral may effectively terminate the debtor's business before there is any realistic opportunity to reorganize. But the Code also requires that adequate protection be constructed in this typically complex transactional setting. Often, the result is a decision favorable to the debtor, subject to significant restrictions. The decision may later be reversed at a final hearing on use of the collateral, or on general relief from the stay, when a more complete view of the debtor's prospects is available.¹⁴⁴

The emphasis of floating collateral cases differs from that of equipment cases with regard to consideration of the debtor's current profitability and prospects for successful reorganization. Feasibility of eventual reorganization is the essential rationale for reorganization cases; if there is no likelihood of success, the process of continued restraint on the creditor becomes meaningless and unnecessarily harmful. In equipment cases, feasibility is generally examined with reference to future prospects not necessarily linked to current profitability. This is consistent with the relatively stable and durable character of the asset. In contrast, in floating lien cases there is greater emphasis on current profitability.¹⁴⁵ This orientation is consistent not only with the nature of the collateral, but also with the essential structure of adequate protection in floating lien cases, which depends on a current profit margin to support replenishment of property and compensation for use.

Since the issue of adequate protection is most often raised shortly after the bankruptcy filing, a substantial burden is imposed on the debtor, and a rapid response to pre-bankruptcy conditions may be required. As a result, profitability is not

Discount Wallpaper Center, Inc., 19 Bankr. 221, 222 (Bankr. M.D. Fla. 1982) (short period of time granted).

143. *Heatron*, 6 Bankr. at 497.

144. Compare *In re Thomas Parker Enters., Inc.*, 8 Bankr. 207 (Bankr. D. Conn. 1981) (debtor granted conditional use of collateral) with *In re Thomas Parker Enters., Inc.*, 10 Bankr. 783 (Bankr. D. Conn. 1981) (stay terminated).

145. See *In re Anchorage Boat Sales, Inc.*, 4 Bankr. 635, 643 (Bankr. E.D.N.Y. 1980).

closely examined in all cases. Furthermore, when profitability is examined, the focus should be on net income above operating expenses, excluding maintenance of unsecured debt obligations. Unsecured debt is not required to be kept current after the case is filed; nor are unsecured creditors entitled to adequate protection. Creditors will derive benefit from successful completion of the case, and their remedy, if necessary to avoid aggravated loss, lies in motions to dismiss or convert the case.

Current profit, defined as net income above operating costs, or at least a break-even level of income is critical to the floating collateral creditor and is viewed as such by the courts. For example, in *In re Thomas Parker Enterprises, Inc.*,¹⁴⁶ during the five months between filing and removal of the stay, current income did not meet operating expenses, resulting in a net loss.¹⁴⁷ Arguably, net loss can be temporarily sustained and covered if there is a surplus of collateral value at the outset. In such a case, without adversely affecting the creditor, the debtor has an opportunity to reduce operating expenses, or otherwise improve profitability, while maintaining compensatory payments. Without such surplus, however, the adverse effect on the creditor is immediate.

A different situation necessarily arises where the debtor's operations are currently profitable under the above definition, or where there are clear indications of a turn in that direction in the immediate future. For example, in *In re Charay Industries, Inc.*,¹⁴⁸ the court, in reaching a decision favorable to the debtor, was strongly influenced by a large net profit experienced by the debtor during the case which tended to ensure adequate replenishment of the collateral. In *Charay*, a prior history of profitability had been interrupted by a short-term drop in sales which had been overcome during the case.¹⁴⁹ Similarly, in *In re Sel-O-Rak Corp.*,¹⁵⁰ financial difficulties caused by aborted expansion plans were apparently sufficiently overcome to project relatively immediate profitability.¹⁵¹

C. COMMERCIAL REAL ESTATE

Commercial real estate lending involves a variety of forms

146. 10 Bankr. 783 (Bankr. D. Conn. 1981).

147. *Id.* at 785.

148. 23 Bankr. 988 (Bankr. E.D. Mich. 1982).

149. *See id.* at 998.

150. 24 Bankr. 5 (Bankr. S.D. Fla. 1982).

151. *See id.* at 6. In *Sel-O-Rak*, the creditor was further protected by a significant cushion of excess collateral value.

encompassing different levels of risk and integration with the debtor's business. While several reported cases involve on-going construction loans or specialized loan formats, the vast majority of cases deal with single installment loans with relatively fixed repayment schedules. These latter cases will be the focus of the ensuing discussion.

Characterized by a relatively large investment connected to a substantial and relatively stable asset, real estate lending resembles equipment financing more than it does floating collateral financing. The real estate lender typically does not establish direct reliance on, or connection to, the debtor's current income, as occurs in the floating collateral context. Instead, the more significant reliance of the real estate creditor is on the current and future value of the secured asset itself.

Despite similarities, a number of features of traditional real estate lending distinguish it from equipment financing. Foremost, the value of the typical commercial real estate loan, at least in the reported bankruptcy cases, is significantly greater than that encountered in equipment financing. This is an average rather than an absolute difference, as there are obviously a number of equipment loans of significant value. In the reported real estate cases, however, loan amounts substantially in excess of one million dollars are common, while they are much less frequent in equipment cases.¹⁵² The large dollar value of the loan obviously shapes the perceived interest of the creditor in terms of eventual recovery as well as current income on investment.

The size of the investment and the nature of the collateral contribute to a second differentiating feature of real estate loans. While short term loans are encountered, especially in secondary financing, the typical real estate mortgage is a relatively long term instrument. This long term orientation is supportable due to the stable or incrementing value of the collateral. While equipment lending involves depreciating as-

152. Compare *In re Selby Farms, Inc.*, 15 Bankr. 372, 373 (Bankr. S.D. Miss. 1981) (real estate loan in excess of \$3,000,000) and *In re Pleasant Valley*, 6 Bankr. 13, 14 (Bankr. D. Nev. 1980) (real estate loan of \$4,925,000) and *In re San Clemente Estates*, 5 Bankr. 605, 606 (Bankr. S.D. Cal. 1980) (creditor committed to loan up to \$5,350,000 to develop real estate) and *In re Stuart Motel, Inc.*, 8 Bankr. 50, 51 (Bankr. S.D. Fla. 1980) (real estate loan in excess of \$1,000,000) with *In re A & A Transport, Inc.*, 10 Bankr. 867, 868 (Bankr. D. Mass. 1981) (debt of approximately \$24,000 on two trucks) and *In re American Mariner Indus., Inc.*, 10 Bankr. 711, 712 (Bankr. C.D. Cal. 1981) (debt secured by machinery, equipment, tools, etc., valued at \$110,000) and *In re Wheeler*, 12 Bankr. 908, 909 (Bankr. D. Mass. 1981) (approximately \$49,000 owed on log skidder).

sets with relatively short useful lives, depreciation in real estate relates solely to improvements on the property, leaving substantial land values which in recent history have increased over time. As a result, the overall collateral value may improve over the span of even a long term loan.

Given the stable value of real estate and likely large investment involved, real estate lenders are often able to insist upon and maintain an equity cushion of excess property value to ensure recovery of their loans. Loans are often made at a percentage of the acquisition cost of the property unless they are designed to support construction or conversion of improvements. The cushion established may vary depending on the existing status of the property. Thus, for example, a greater percentage of excess value would be required for raw land than for improved real estate. Since property values do not deteriorate rapidly, payment schedules can often maintain this cushion over the life of the loan.

1. Core Protection

In the context of equipment and inventory loans, core protection of recoverable value to the creditor is a significant issue in virtually every case due to depreciation or consumption of the property. In contrast, in the reported real estate cases, courts seldom raise the issue of a decline in the actual value of the collateral. In a few cases, market value declines are alleged, but it is equally common that the property is appreciating in value.¹⁵³ The risk that improvements will be destroyed or damaged by unexpected events is typically covered by requirements that the debtor maintain insurance.

The most common, albeit relatively rare, form of threat to recoverable value involves multiple creditor cases in which the creditor seeking protection is a junior lienholder. The senior liens may be prior mortgages or accruing tax liens. In the case of a senior mortgage, since the senior lender is typically oversecured, interest on its claim accrues under section 506.¹⁵⁴ This interest adds to the senior debt and may force the junior creditor into an increasingly undersecured position, effectively reducing the recoverable value of the property to the junior

153. See *In re Boca Dev. Assocs.*, 21 Bankr. 624, 628 (Bankr. S.D.N.Y. 1982); *In re Certified Mortgage Co.*, 17 Bankr. 225, 226 (Bankr. M.D. Fla. 1982); *In re Pleasant Valley, Inc.*, 6 Bankr. 13, 17 (Bankr. D. Nev. 1980); *In re Rogers Dev. Corp.*, 2 Bankr. 679, 685 (Bankr. E.D. Va. 1980).

154. See 11 U.S.C. § 506 (Supp. V 1981).

creditor. In such cases, courts typically respond by requiring the debtor to pay interest to the senior lienholder or to make compensatory payments to the junior claimant based on the rate of increase in senior claims.¹⁵⁵

The second core issue involves the debtor's need for the property. This issue, as it applies to real estate cases, received substantial attention in the development of the current Code. As proposed by the Senate, the Code required that a stay be terminated if the debtor lacked an equity interest and the property was not necessary to the reorganization. This requirement was buttressed by a statutory presumption that the property was not necessary if it was "real property on which no business is being conducted other than operating the real property and activities incidental thereto."¹⁵⁶ The objective was to eliminate bankruptcy abuses associated with highly leveraged, tax shelter investments. Although the "no equity" test was retained as a ground for relief from a stay, the statutory presumption was deleted from the final draft of the Code.¹⁵⁷

Although the resulting standard plays a role in real estate cases, the question of need for the property is seldom controversial in business cases. Instead, the courts have generally adopted a "debtor-centered" interpretation of need. Under this view, the debtor is able to determine whether to continue to use the property and to select from several parcels of real estate those which will be retained.¹⁵⁸ The question of need is primarily an issue in consumer cases under Chapter 13 and section 362(d)(2) of the Code.¹⁵⁹

2. Reconstructing the Bargain

In a context where core protection is seldom a major issue, the decisional process concentrates on issues related to rebuilding the initial bargain and balancing behavioral factors.

155. See, e.g., *In re American Properties, Inc.*, 8 Bankr. 68, 72 (Bankr. D. Kan. 1980).

156. S. REP. NO. 989, 95th Cong., 2d Sess. 52-53, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5838-39.

157. See 11 U.S.C. § 362(d)(2) (Supp. V 1981).

158. See *Nimmer*, *supra* note 7 at —. See also *In re Mickler*, 13 Bankr. 631, 633 (Bankr. M.D. Fla. 1981).

159. In Chapter 13 actions, relatively stringent standards of need are often applied with emphasis on absolute need or benefit as contrasted to mere convenience. See *In re Rodebaugh*, 12 Bankr. 81, 82 (Bankr. D. Me. 1981); *In re Roselli*, 10 Bankr. 665, 667 (Bankr. E.D. Pa. 1981); *In re Suter*, 10 Bankr. 471, 472 (Bankr. E.D. Pa. 1981). Compare *In re Sulzer*, 2 Bankr. 630, 634-35 (Bankr. S.D.N.Y. 1980) (Chapter 11) with *In re Garner*, 18 Bankr. 369, 371 (S.D.N.Y. 1982) (Chapter 13).

With reference to the creditor's bargain, the primary emphasis has been on the presence or absence of an equity cushion and on the creditor's right to receive interest on its typically substantial investment.

The idea of an "equity cushion" that relates to adequate protection of a real estate creditor was first stated in *In re Pitts*,¹⁶⁰ a case arising under Chapter 13. In retaining the stay against foreclosure of a residential mortgage, the court in *Pitts* noted:

The existence of an equity [cushion], in terms of collateral value in excess of the secured creditor's claim, is an elementary and fundamental part of the transaction. True, the secured creditor assumes the risk that default and sale may occur at a time when the market is depressed so that foreclosure and sale may not . . . pay the claim. However, to deprive the secured creditor of the right to proceed with foreclosure at a time when a cushion exists and to compel postponement of his remedy in the face of a clearly foreseeable possibility that the cushion may disappear, is to expose the secured creditor to risks which were not part of the bargain.¹⁶¹

Describing the existing cushion as "minimal," the court retained the stay subject to continuing review of the adequacy of the cushion. Since *Pitts*, the concept of an equity or value cushion has been a major theme in the reported real estate cases.¹⁶²

In the absence of depreciation or accruing senior interests, the idea of an equity or value cushion does not relate to the core protection of the creditor's recoverable value. Indeed, although other cases suggest that there is a connection, the court in *Pitts* expressly acknowledged that a cushion in a real estate case is typically not important to protect against a decrease in the creditor's interest in the property. Under section 506, the presence of even a minimal cushion allows the creditor's interest to *increase* through accrued interest up to the value of its collateral.¹⁶³ Certainly, the mere absence of surplus equity

160. 2 Bankr. 476 (Bankr. C.D. Cal. 1979).

161. *Id.* at 478.

162. The "equity cushion" analysis has been described as "the most important" line of cases involving adequate protection under the Code. Schimberg, *Uniform Commercial Code Annual Survey: Secured Transactions*, 36 BUS. LAW. 1347, 1396 (1981). In practice, the equity cushion is occasionally mentioned in cases involving other forms of collateral, but it is a major analytical theme only in real estate cases.

163. One commentator has suggested that this result is not necessarily required under § 506. See O'Toole, *supra* note 44, at 271-72. In practice, however, this result is commonly assumed by the courts and may serve to explain the substantial attention apparently devoted to the presence of an equity cushion in real estate cases.

does not indicate that the property value and secured claim will *decline* during the stay period.

The judicial emphasis on equity cushions is related to either of two other objectives, or a combination of both. The first is an effort to reconstruct that part of the real estate loan transaction that tends to ensure the creditor of an equity cushion throughout the transaction. In this regard, several courts have held that a more substantial cushion is required in cases involving a mortgage on raw land.¹⁶⁴ This view tracks traditional lending practices which tend to calibrate the required equity to the type of real estate serving as collateral. The second objective is to ensure that the creditor is compensated with interest on its loan over the period of the stay. Under section 506 of the Code, post-petition interest is allowed to accumulate on the claim of an oversecured creditor. In the case of an undersecured creditor, interest can be made a part of adequate protection only through special orders to that effect.

Even if one accepts the premise that an equity cushion forms a part of the essential value of a real estate loan that should be reconstructed to provide adequate protection, it is erroneous to treat the absence of an equity cushion as cause for relief. In bankruptcy, the individual creditor's bargain encompasses not only the original transaction, but also the manner in which the parties performed subsequent to the loan. The absence of an equity cushion at the time of filing is commonly attributable to the nature of the original loan, or to the subsequent course of performance. In either event, it cannot be said that a particular creditor in such an instance bargained for the protection of an equity cushion. Furthermore, it is not the role of adequate protection to recreate a transaction in a way that improves the creditor's position by eliminating a risk the creditor has already assumed. Where an existing cushion has been depleted due to improper conduct by the debtor, the stay can be terminated based on behavioral, rather than financial, reasons.

While some language in the cases indicates that the absence of a cushion is *per se* cause for relief, viewed as a whole and in their factual contexts, the cases generally conform to the analysis set forth above. In over one-third of all reported cases where there was no equity cushion, the stay was retained.¹⁶⁵

164. See *In re High Sky, Inc.*, 15 Bankr. 332, 336 (Bankr. M.D. Pa. 1981); *In re Lake Tahoe Land Co.*, 5 Bankr. 34, 37 (Bankr. D. Nev. 1980).

165. See, e.g., *In re Waynesboro Hotel Co.*, 19 Bankr. 561 (Bankr. M.D. Pa.

Furthermore, in a majority of the cases where there was no equity cushion and the stay was removed, there were behavioral explanations related to excessive delay or bad faith, or indications that reorganization was not feasible.¹⁶⁶ The view that the contours of an existing bargain should be retained does not imply creation of a new protective bargain for the parties after bankruptcy. Where no cushion exists, the issue should be whether behavioral and feasibility issues justify retention or termination of the stay. That is precisely the question that appears to control in most cases.

Where an equity cushion exists at the time a petition is filed, a more difficult conceptual issue is presented. In these cases, the creditor bargained for and acted so as to retain a transactional right to a cushion. The issue in bankruptcy becomes whether this bargained for right should be protected. In cases where an incrementing claim reduces the cushion, for example, does adequate protection require protection against deterioration of the buffer or, if that protection is not available, termination of the stay?

The apparent answer to this question is that the right to an equity cushion is protectable in bankruptcy only if it has been protected and retained by the creditor prior to bankruptcy. Retention of an equity cushion is designed to ensure collection of the loan notwithstanding inaccuracies in valuation of the collateral, vagaries in the real estate market, or foreclosure costs. None of these variables are predictably altered by the stay, but they represent risks inherent in the type of collateral involved, and the retention of a cushion may be viewed as an important safeguard against their operation where substantial loans are typically at stake. As a result, courts often view a deteriorating cushion as a potential cause for relief or as a reason to require offsetting cash payments.¹⁶⁷

Although protection of the equity cushion has a role in the reported cases, at least two factors make its ultimate impor-

1982); *In re Selby Farms, Inc.*, 15 Bankr. 372 (Bankr. S.D. Miss. 1981); *In re American Properties, Inc.*, 8 Bankr. 68 (Bankr. D. Kan. 1980); *In re Bianco*, 5 Bankr. 466 (Bankr. D. Mass. 1980).

166. See, e.g., *In re Day Resource & Dev. Co.*, 21 Bankr. 176, 178-79 (Bankr. D. Idaho 1982); *In re Accent Assocs.*, 8 Bankr. 933, 936 (Bankr. D. Mass. 1981); *In re Clark Technical Assocs.*, 9 Bankr. 738, 740-41 (Bankr. D. Conn. 1981); *In re Royal d'Iberville Corp.*, 10 Bankr. 37, 39 (Bankr. S.D. Miss.), *aff'd*, 12 Bankr. 149 (S.D. Miss. 1981).

167. See *In re Certified Mortgage Co.*, 20 Bankr. 787, 788 (Bankr. M.D. Fla. 1982); *In re Gaslight Village, Inc.*, 8 Bankr. 866, 871 (Bankr. D. Conn. 1981); *In re H & F Inv. Co.*, 9 Bankr. 548, 549 (Bankr. N.D. Ohio 1981).

tance questionable. Initially, although the creditor is entitled to protection of a cushion retained prior to bankruptcy, courts have not typically held that the cushion must be retained at the pre-bankruptcy level. Instead, the creditor is held to be entitled to protection of that part of its cushion the court deems adequate, with some uncompensated deterioration clearly allowed.¹⁶⁸ If the cushion is viewed as part of the creditor's bargain, this approach clearly alters bargained-for rights. It is, however, an appropriate balancing of the conflicting claims of creditors and debtors. Unlike depreciation and replenishment in other contexts, a cushion is a secondary right that can, at least in part, be sacrificed to permit the debtor an opportunity to reorganize.

In addition, conclusions regarding the existence of a cushion, and its deterioration or stability, are the result of a contingent, equitable process that may hinge on judgments about behavioral equities. Although summarized by specific dollar amounts, property valuation is an uncertain process of estimation.¹⁶⁹ In the typical bankruptcy case, a court is faced with widely divergent expert estimates of value. The court's resolution of this conflict may reflect its views of the behavioral equities and the feasibility of reorganization.¹⁷⁰

The equity cushion analysis is inextricably linked with the question of the real estate lender's entitlement to compensation for opportunity cost in the form of interest on its claim. In a majority of the reported cases in which the stay was retained, courts protected the creditor's right to receive interest.¹⁷¹ Most of these cases, however, involved protection under section 506 by virtue of an equity cushion. No consistent pattern of compensation to the real estate creditor for its investment is apparent in cases where no cushion was present.¹⁷²

Real estate loans are typically not an appropriate context

168. See, e.g., *In re Hewitt*, 16 Bankr. 973, 980 (Bankr. D. Alaska 1982); *In re Hurricane Resort Co.*, 16 Bankr. 598, 599-600 (Bankr. S.D. Fla. 1981); *In re Comose*, 7 Bankr. 854, 856 (Bankr. S.D. Fla. 1980).

169. See *In re Pitts*, 2 Bankr. 476, 478 (Bankr. C.D. Cal. 1979).

170. See *Nimmer*, *supra* note 7, at —.

171. See, e.g., *In re Hewitt*, 16 Bankr. 973, 981 (Bankr. D. Alaska 1982); *In re Bristol Mountain Enters., Inc.*, 13 Bankr. 412, 417 (Bankr. W.D.N.Y. 1981); *In re Graydon*, 8 Bankr. 475, 479 (Bankr. S.D. Fla. 1981).

172. See, e.g., *In re Monroe Park*, 17 Bankr. 934, 940 (D. Del. 1982) (interest allowed); *In re South Village, Inc.*, 25 Bankr. 987, 990 (Bankr. D. Utah 1982) (interest denied); *In re American Properties, Inc.*, 8 Bankr. 68, 71-72 (Bankr. D. Kan. 1980) (monthly payments to compensate for decreasing value of security interest); *In re El Patio, Ltd.*, 6 Bankr. 518, 522 (Bankr. S.D. Cal. 1980) (payments of two per cent of the secured claim per year).

for protection of reinvestment value per se. As indicated previously in comparing equipment liens and floating collateral liens, this form of protection is not typically implemented on the basis of a creditor's inherent right to receive interest. Instead, in bankruptcy, protection of reinvestment value is based on compensation for particular risks in the loan transaction. In this regard, real estate, being stable collateral, is significantly more akin to equipment than to floating accounts in that there are no substantial or unique risks of value loss. A right to receive interest should be acknowledged, however, on an equitable basis in appropriate cases. In contrast to loans secured by personal property, commercial real estate loans often involve sums substantially in excess of one million dollars. In such cases, retaining a stay without compensatory interest can produce substantial financial loss for the creditor. As a matter of equity this loss should be compensated, especially where it will not destroy existing opportunities for reorganization.

3. Behavioral Factors

In real estate cases, core protections are seldom an issue. In addition, issues of valuation, protecting a cushion, and compensating for investment are generally treated in variable, rather than absolute terms. As a result, behavioral factors are significantly more important in resolving adequate protection issues. These behavioral factors have been extensively discussed in another context.¹⁷³ In general, the operative patterns are fully consistent with earlier discussions in this Article. The following discussion will briefly review some major issues that offer relevant comparisons to the other types of collateral previously discussed.

Courts in real estate cases have been more susceptible to the influence of pre-petition events than have courts considering other forms of collateral. In several reported cases, the creditor's pre-petition conduct has had a major impact on resolution of the adequate protection issues. Often, this conduct involves special risk assumption by the creditor. For example, in *In re Orlando Coals, Inc.*,¹⁷⁴ although relief from the stay was sought shortly after bankruptcy was filed, it was denied when the court found that the creditor had previously accepted a long period of pre-petition default without taking action to foreclose. The creditor's conduct was treated as virtually estopping

173. See Nimmer, *supra* note 7, at —.

174. 6 Bankr. 721 (Bankr. S.D. W. Va. 1980).

immediate post-petition action. This result is consistent with the earlier point that the creditor's bargain is defined not only by the terms of the original loan, but also by the subsequent conduct of the parties.

The real estate cases also most clearly and extensively illustrate that inequitable pre-petition conduct by the debtor may lead to a denial of the automatic stay. Unlike inventory cases, this conduct typically does not involve misrepresentation of assets. Instead, a frequent pattern involves repetitive filing and dismissal of bankruptcy petitions designed to delay the creditor's foreclosure, rather than to obtain a reorganization.¹⁷⁵ A number of other cases involve a transfer of assets on the eve of bankruptcy to a new entity that subsequently files bankruptcy before foreclosure can be completed.¹⁷⁶ In these settings, the debtor's conduct may override other factors and lead to termination of the stay notwithstanding adequate financial protections.

Assuming no inequitable conduct, the emphasis of the cases is on the timing of the request for relief and the feasibility of efforts to reorganize. On both of these points, the real estate cases parallel the cases discussed previously, but differ in degree and tone. For example, real estate cases generally involve an elongated time frame. In many cases, pre-petition defaults are in excess of one year and requests for relief are often filed more than six months after filing of the original bankruptcy petition.¹⁷⁷ The tendency to continue the stay even at this late time reflects an apparent willingness on the part of courts and creditors to allow more time to elapse before denying the debtor continued use of the property. This conduct is due in part to the relatively stable value of the collateral and the relatively lengthy foreclosure procedures required outside of bankruptcy. Against this background, the length of time from filing to request for relief does not appear to seriously prejudice the debtor until the time interval approaches one

175. See, e.g., *In re Andrews*, 17 Bankr. 515, 519 (Bankr. C.D. Cal. 1982); *In re Pappas*, 17 Bankr. 662, 666-67 (Bankr. D. Mass. 1982).

176. See, e.g., *In re Zed*, 20 Bankr. 462 (Bankr. N.D. Cal. 1982); *In re Lotus Invs. Co.*, 16 Bankr. 592 (Bankr. S.D. Fla. 1981). But see, e.g., *In re Beach Club*, 22 Bankr. 597 (Bankr. N.D. Cal. 1982) (stay retained notwithstanding transfer).

177. See, e.g., *In re Boca Dev. Assocs.*, 21 Bankr. 624 (Bankr. S.D.N.Y. 1982); *In re Brogdon Inv. Co.*, 22 Bankr. 546 (Bankr. N.D. Ga. 1982); *In re Comer*, 18 Bankr. 969 (Bankr. M.D. Pa. 1982); *In re Hewitt*, 16 Bankr. 973 (Bankr. D. Alaska 1982); *In re Koopmans*, 22 Bankr. 395 (Bankr. D. Utah 1982); *In re Graydon*, 8 Bankr. 475 (Bankr. S.D. Fla. 1981); *In re Hurricane Resort Co.*, 16 Bankr. 598 (Bankr. S.D. Fla. 1981); *In re Comose*, 7 Bankr. 854 (Bankr. S.D. Fla. 1980).

year or more.¹⁷⁸ Similarly, although the feasibility of and efforts toward reorganization are recurring issues, courts in real estate cases involving business debtors do not typically engage in the close analysis of business prospects that characterizes floating lien cases. Since real estate loans are seldom closely connected to current cash flow or operations, courts have justifiably placed little emphasis on the current profitability of the debtor. Where feasibility is an issue, it is most often addressed by focusing on lengthy periods of loss, or on the fact that business operations are closed down.¹⁷⁹ In contrast, however, especially where real estate is the sole asset of the business and there is essentially only one creditor, courts may pay particular attention to the feasibility of obtaining financing for reorganization or confirmation of the plan over the dissent of that creditor.¹⁸⁰

V. CONCLUSION

This Article has examined a range of case law involving the automatic stay in bankruptcy. The analysis reveals that courts have applied different standards to various types of secured transactions. For the most part, these standards have been implicit, with no express statement that different contexts require different analytical frameworks. One result of the implicit application of differential standards is a tendency to generalize about adequate protection issues, or to seek unidimensional models to provide explanation or guidance. This Article indicates that although a model which explains the cases and guides the courts toward appropriate policy decisions can be formulated, such a model must be derived at a level that permits significant substrata differentiation.

The Bankruptcy Code provides limited guidance as to the meaning of terms such as "adequate protection" or "cause" in

178. See, e.g., *Ukrainian Sav. & Loan Ass'n v. Trident Corp.*, 22 Bankr. 491 (E.D. Pa. 1982); *In re Clark Technical Assocs.*, 9 Bankr. 738 (Bankr. D. Conn. 1981); *In re Gaslight Village, Inc.*, 8 Bankr. 866 (Bankr. D. Conn. 1981); *In re Mikole Devs., Inc.*, 14 Bankr. 524 (Bankr. E.D. Pa. 1981); *In re Oak Manor Homes, Inc.*, 17 Bankr. 84 (Bankr. S.D. Ohio 1981).

179. See, e.g., *In re Kingman Warehouse Co.*, 17 Bankr. 377, 382 (Bankr. D. Iowa 1982); *In re Accent Assocs.*, 8 Bankr. 933, 936 (Bankr. D. Mass. 1981); *In re Allison Corp.*, 9 Bankr. 827, 828 (Bankr. S.D. Cal. 1981); *In re H & F Inv. Co.*, 9 Bankr. 548, 548 (Bankr. N.D. Ohio 1981).

180. See, e.g., *In re Day Resource & Dev. Co.*, 21 Bankr. 176, 178 (Bankr. D. Idaho 1982); *In re Pine Lake Village Apartment Co.*, 19 Bankr. 819, 826 (Bankr. S.D.N.Y. 1982); *In re Castle Ranch of Ramona, Inc.*, 3 Bankr. 45, 48 (Bankr. S.D. Cal. 1980).

the context of the automatic stay. As the legislative history attests, however, such ambiguity was fully intended. The purpose of the Code is to permit judicial flexibility responsive to changing economic environments and differing transactional contexts.

Nevertheless, there has been a tendency to attempt to force adequate protection analysis into a monolithic framework focused entirely on financial protections. This Article discussed two purported models of adequate protection that, although oriented to diametric results, share this conceptual limitation. The first model tends to view adequate protection as solely concerned with protecting the recoverable value of the property to the creditor. This view fails to capture the diversity and richness of the reported case law, or to reflect the complex assessment required by the Code. Equally significant, it would sacrifice significant creditor interests in favor of a uniformly pro-debtor standard. The second model tends, on the other hand, to view adequate protection as encompassing not only recoverable value, but also compensation for lost investment opportunities in all cases. Again, the analysis captures neither the diversity of the case law nor the analysis necessary under the Code.

In this Article a third, multi-factor model for examining adequate protection issues was formulated and applied to current case law. This analysis has demonstrated that the model is consistently applied with reference to various types of collateral. Consistent with the cases, the analysis generates results that are contextually and behaviorally variant. In essence, the proposed model recognizes that adequate protection is not a unidimensional concept, but an analytical framework oriented toward adjusting the rights of entities with conflicting claims to particular property. Such adjustment necessarily reflects the full range of factors that define the conflicting interests.

The proposed model involves three major levels of analysis. The first consists of core protections oriented to protecting the creditor's recoverable value from the property. The nature of existent threats to recoverable value varies with the type of property involved. Issues of depreciation are commonly associated with equipment, while replenishment of property that has been sold or consumed is dominant with reference to floating collateral. Necessarily, the cases track the nature of the threat and develop distinct protective schemes. Significantly, however, some responsive form of protection of the core interest is

required in all cases. This requirement flows directly from the Code, and establishes a financial baseline to protect individual creditors and to facilitate general patterns of secured financing.

The second level of analysis is more complex and the statutory guidance less explicit. It consists of efforts to restructure and preserve essential elements of the bargain between the parties, while providing the debtor a reasonable opportunity to reorganize. Pertinent variables include cash flow to the creditor, interest on the investment, and maintenance of the equity cushion built into the transaction. The thrust of this level is not that the creditor is entitled to the full benefit of the bargain. Indeed, although all the variables are components of most secured loans, they are not invariant aspects of adequate protection. Rather, they are selectively applicable based on analyses of the peculiar risks and transactional importance associated with various forms of secured lending.

The three areas of secured finance discussed herein evoke distinct and sharply differentiated protective responses. Across the board, floating lien financing involves the greatest risk to the creditor and the closest interaction between the debtor and creditor. Cases involving this type of financing routinely evoke the broadest array of protective mechanisms including compensation for investment and risk. In contrast, equipment financing is viewed as the least risky and interactive. Protections commonly safeguard no more than the core of recoverable value. Real estate loans fall somewhere between these extremes, not because of enhanced risks, but because of the size of the investment and the creditor's external ability to obtain and retain equity protection for its investment.

The third level of analysis is behavioral and focuses on contextual factors that strengthen or weaken the debtor's claim to continued use of the property. This aspect of the analysis most clearly identifies the equitable base of adequate protection questions. As this Article has indicated, several themes reappear in the cases. Each of these themes is consistent with viewing the automatic stay as conferring a limited term equitable right on the debtor to retain use of the collateral. This right is premised on overall reorganization goals. Thus, the debtor's ability to retain the stay is clearly related to the particular stage of the proceedings and the debtor's apparent ability to effectuate a reorganization. The right, however, is also related to the quality of the debtor's efforts, prior to and during the case, to protect and deal fairly with the creditor.

The three-level analysis suggested by this model is complex, but is congruent with the Code and with the context of a bankruptcy reorganization. That context requires consideration of numerous variables, with the creditor's bargain and financial protection as relevant bench marks. As illustrated in this Article, such bench marks lead to different forms of protective arrangements related to different forms of secured finance. The courts' adaptation to these different contexts within the environment of a single statutory mandate reflects the inherent benefits of case-by-case resolution of complex issues.